corospondent

The Institutional Quarterly

Ruffled feathers

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CORONATION
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IN THIS ISSUE

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Kirshni on point

In the cold light of day

By Kirshni Totaram

WELCOME TO OUR winter edition of *corospondent*. The uncertainty felt in the markets through the first half of the year still lingers, but this mid-year break brings the perfect chance for me to reflect on what is truly important for our clients right now.

We know it's tough out there. There are high levels of fatigue. Concern about economies and markets continues, and confidence remains depressed. With growth in South Africa being anaemic and the global geopolitical environment in turmoil, a calm sense of clarity is needed to navigate these tough times.

HOME TRUTHS FOR SOUTH AFRICA

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

The elections are now behind us. Infighting within the ANC has continued and although disappointing, it is not totally unexpected. Critically, however, is that it serves as a distraction from the work needed on policy reform, most importantly addressing the sustained decline of state-owned enterprises.

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In his State of the Nation address in June, President Ramaphosa disappointingly gave little detail on how they would be managed. He did signal that Eskom will receive additional financial support from government, thus increasing the debt on our country's already strained balance sheet.

The ugly reality of South Africa's growth was plain to see with Statistics South Africa's quarterly numbers reporting a decline of 3.2% – the largest quarterly decline in 10 years. In her review of the South African economy on page 7, Coronation economist Marie Antelme points out that the economy is unlikely to grow by more than 1% in real terms in 2019. She looks into the very weak growth and the effects on South Africa's long-term ability to manage the structural challenges it faces. On a more positive note though, looking ahead, a modest, cyclical improvement in growth is expected.

GLOBAL LEADERS BATTLE FOR GEOPOLITICAL SUPREMACY

The US-China trade war shows no signs of abating, despite some encouraging steps and comments from US President Donald Trump and China's President Xi Jinping at the G20 Summit in Osaka. On page 5, internationally renowned economist Professor Barry Eichengreen unpacks the current status of the trade war, which has moved beyond trade tariffs and become a battle for geopolitical supremacy revolving around technology. The reality is that it doesn't bode well for US-China trade relations, for the global trading system or macroeconomy, and he explains why mainstream analysis fails to account for the investment and supply chain impact of the tensions.

SEEING VALUE IN THE FAST LANE

The global media landscape is shifting dramatically, given changes in consumer viewing habits enabled by new technology and new players. How audiences consume content has changed fundamentally, and producers are in a fierce battle for viewership. The diversity of channels has made it harder for producers to monetise content. But for various reasons, as global developed markets analyst John Parathyras points out in his article on page 10, one valuable exception is sports content. Formula 1 is listed, making it the only truly global sporting franchise that provides investors with access to a top sporting event.

The rules are also changing for luxury brands as a whole in this increasingly digital world. Many are struggling to keep apace, while others are thriving in this new paradigm. On page 14, equity analyst Lisa Haakman takes us into the world in which customer relationships with luxury goods are deeply emotive and personal, highlighting which brands we believe are particularly attractive.

BUT THE GRASS IS NOT ALWAYS GREENER

There are certainly gems like these to be found globally where we are seeing value. But in keeping with looking at things in the cold light of day, in this edition we also consider that many South African companies have expanded offshore, straying away from core competencies, but few have truly succeeded abroad. The deteriorating economic conditions have eroded seemingly sound investment cases. In his article on page 21, portfolio manager Quinton Ivan unpacks why the grass isn't always greener offshore and uses the unfortunate acquisition experiences of Woolworths and Sasol as examples.

THE SECRET WEAPON OF CULTURE

In closing, what is most clear to me is that when times are tough and the world around you is scrambling for a piece of the pie, having a strong culture in your organisation is one of the most powerful stabilisers, and indeed a competitive advantage. Culture is a great anchor, building internal strength and cohesion. At Coronation, our unique culture and value system glue us together. It is not just a quote on our website, but what happens on the ground. We live it every single day, giving us purpose and clarity. Looking forward, the clarity that comes from our long-term investment philosophy, a client-centric culture and the cohesion among our highly skilled team of people is of great benefit in managing our clients' money to best advantage.

We wish you well as we enter this second half of 2019 and thank you for your valued trust and support.

Enjoy the read.

Kirshni

GLOBAL ECONOMY

Trump's trade war: even worse than you think

By Professor Barry Eichengreen

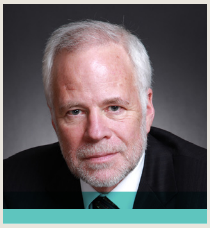
THE TRADE WAR between the US and China is not ending anytime soon, notwithstanding the efforts of presidents Trump and Xi to make nice on the sidelines of the Osaka G20 Summit. Trump signaled as much, hedging his 'no new tariffs' pledge with a telling "at least for the time being", and noting that "I [still] have the ability to put on [a tariff] if I want to".

These remarks should not come as a surprise, for they are a reflection of Donald Trump's personality and politics. Trump thrives on chaos. He likes nothing more than keeping his enemies and indeed his friends, such as they are, off guard. And nothing is more effective at creating chaos than Trump's tariff tweets. In addition, blaming China for US economic problems is a convenient way of distracting attention from their domestic causes and from the President's failure to alleviate them.

China for its part is a proud country whose leaders have no intention of backing down in the face of threats. Chinese leaders perceive Trump's demands through the prism of the Opium Wars and the humiliating concession of treaty ports to Western powers by the Qing Dynasty in the 19th century. The more aggressive the US President's attacks, therefore, the less likely is a negotiated solution.

Moreover, the trade war is now seen by both sides as part of a larger geopolitical conflict. This is a conflict over geographical spheres of influence, starting with the South China Sea but increasingly encompassing the globe. It is a conflict over who possesses the technological high ground and how economic policy can shift the technological balance. Trade, any economist will tell you, is a positive-sum game in which both sides stand to benefit. The struggle for geopolitical supremacy, on the other hand, is a zero-sum game that only one country can win. The most consequential change in the trade-policy debate in the course of the last year, therefore, is that trade has come to be seen as subordinate to this struggle for geopolitical primacy.

Barry Eichengreen is a professor of economics and professor of political science at the University of California, Berkeley.



ECONOMIC FALLOUT

With what consequences for the economy, one might ask? Mainstream analyses suggest that the macroeconomic effects of a US-China trade war are likely to be small. US-China trade is less than 1% of global GDP. Even in a full-scale trade war between the two countries, most of their previous imports from one another would simply be sourced from third countries. To the extent that there is nevertheless a negative impact on aggregate demand, this would be offset by appropriate adjustments of monetary and fiscal policies. Or so mainstream economic models suggest.

Thus, three economists at the Dutch Central Bank have used a global macroeconomic model to estimate the effects of a 10% US tariff on imports from China, together with tit-for-tat Chinese retaliation. They find that these policies will depress global GDP by just 0.1% after one year and 0.5% after three to four years. The Organisation for Economic Co-operation and Development similarly estimates, using its in-house model, that if the US and China imposed 25% tariffs on each other's exports, global GDP will be just 0.7% lower by 2021 than otherwise.

Three European Central Bank economists, assuming a 10% increase in US and Chinese tariff and nontariff barriers on imports from one another and simulating a suite of multicountry econometric models, conclude that global GDP will be just 0.8% lower after a year.

But the sharp negative reaction of stock markets to Trump's tariff tweets is hard to reconcile with these sanguine conclusions. Moreover, many >

economists instinctively feel that a trade war would inflict significant damage on the economy and the prospects for growth and profitability. They are just unable to back up this intuition using standard models.

UNCERTAINTY AND ITS IMPACT ON INVESTMENT

So, what do these models miss?

First, they miss uncertainty and its impact on investment. If the trade war persists, it will make sense for US firms building productive capacity in China or purchasing inputs from Chinese suppliers to shift their capacity and sourcing to marginally higher cost locations, be these Vietnam, Mexico or the US itself.

Likewise, Chinese companies that previously contemplated expanding their domestic assembly operations with exports to the US in mind may have reason to invest abroad even though overseas costs of production are marginally higher. But if the threatened tariffs never come into effect or turn out to be ephemeral, then relocating production will have been a costly mistake, given sunk costs and irreversibilities.

The Baker-Bloom-Davis Index of trade-policy uncertainty for the US shows major spikes around each of Trump's trade policy statements and tweets. In these circumstances, it clearly pays to wait. Hence, even if the trade war has very limited implications for capital accumulation in the long run, it can still have a large impact in the short run, as uncertain investors hold off making commitments. The consequent sharp fall in investment will then be amplified by multiplier effects familiar from standard business-cycle models, with a large short-run impact on GDP.

Second, standard models miss the negative impact of the trade war on global supply chains. A trade restriction that raises the cost or reduces the availability of imported inputs essential to production in a first sector, by reducing that sector's output, can have a magnified impact on the output of a second downstream sector that uses the output of the first sector intensively in production. As these supply-chain disruptions ramify through the economy, their aggregate impact can be greatly amplified. This kind of nonlinear propagation is not something that is captured by conventional macroeconomic models.

As a case in point, economists have studied the 2011 Fukushima earthquake, Fukushima being an important supplier of electronic components and auto parts. While the earthquake was immediately responsible for a 3% decline in output in a region comprising 5% of the Japanese economy – and hence for just one-fifteenth of a percent decline in Japanese GDP – the aggregate effect resulting from propagation and amplification via supply chains was fully eight times as large.

Finally, standard models miss the impact of trade restrictions on the intensity of competition. The importance of import competition in applying pressure for domestic firms to maximise efficiency has been invoked in a variety of contexts.

For example, the economic historians Stephen Broadberry and Nicholas Crafts attribute the slow growth of productivity in the UK in the third quarter of the 20th century to the anticompetitive effects of the tariffs put in place in the 1930s and then to postwar Britain's failure to join the European Economic Community. A large literature criticises import substitution in Latin America in this same period owing to its tendency to suppress the chill winds of competition.

Thus, a tariff meant to "make America great again" may only make America fat and lazy again. This should especially be a concern when there already are worries about dominant firms, in high tech and elsewhere, facing limited domestic competition.

There are multiple reasons, then, for thinking that the negative effects of President Trump's trade war will be greater than suggested by textbook macroeconomics.

WHAT IS THE PROSPECT OF A TRADE TRUCE?

This returns us to the question: is there any prospect of a trade truce between the US and China that might avoid these damaging consequences? One possibility is the inauguration in 2021 of a new US president who lacks Trump's antipathy toward trade and fear of China. But few of Trump's prospective general-election rivals are free traders themselves, to put an understated gloss on the point.

The most we can hope for is that the next US president will seek to build a coalition of like-minded countries to push for reform of China's policies toward intellectual property and forced technology transfer, and that (s)he will seek to influence that country's behaviour by strengthening rather than destroying the rules-based trading system.

But the notion that the US and China are now in a struggle for geopolitical supremacy that revolves around technology, and whose outcome will be shaped by trade, is here to stay, regardless of who occupies the Oval Office. The controversy over Huawei and 5G is just the canary in the coalmine. This reality does not bode well for US-China trade relations, for the global trading system, or for the global macroeconomy. ✚

SOUTH AFRICAN ECONOMY

A winter of discontent

The economic cost of rent seeking

By Marie Antelme

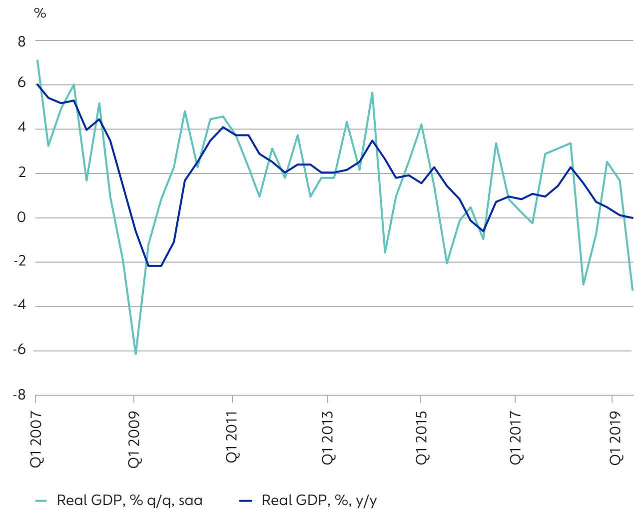
Marie is an economist with 18 years' experience in financial markets.

THERE IS NO shortage of articles, policy papers and opinion pieces detailing how weak South Africa's economic growth has become, why this has happened and what remedial action needs to be taken to improve the situation. Some offer very sensible advice. Some don't. What is seldom articulated clearly is what the effects of this very weak growth are and what they mean for the country's long-term ability to manage the structural challenges it faces.

South Africa's economy is unlikely to grow by more than 1% in real terms in 2019. This follows growth of just 0.7% in 2018. After two positive quarters of growth in the second half of 2018 (H2-18), GDP contracted by 3.2% quarter on quarter, seasonally adjusted and annualised (q/q, saa). This was the worst fall since the -6.1% q/q, saa contraction in the first quarter of 2009 >

(Q1-09) over a decade ago, at the height of the Global Financial Crisis when the economy lost almost a million jobs in one year! This recent weakness was exacerbated by electricity outages that intensified in March, but was ultimately broad based, with real output falling across the primary, secondary and tertiary sectors. When measured on an annual basis, real GDP was flat.

GDP, % YEAR ON YEAR AND ANNUALISED



Source: Statistics South Africa

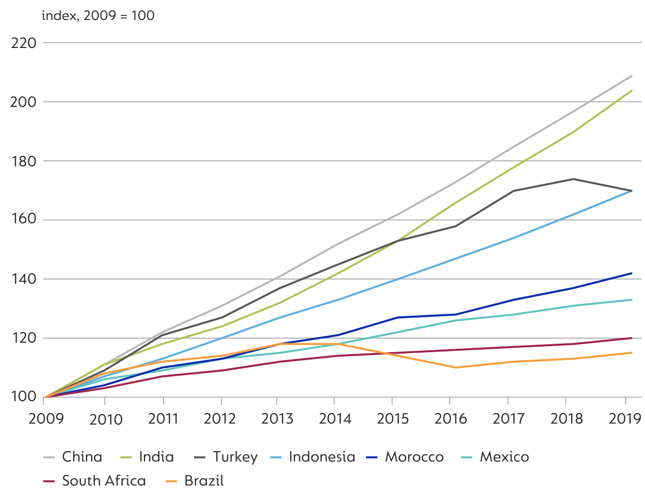
AS COMPARED TO LAST TIME ...

A closer look at expenditure-side data shows very worrying details: real household consumption, which accounts for 62% of GDP and is usually a solid anchor for growth, contracted by 0.8% q/q, following 3.2% q/q growth in Q4-18, shaving 50 basis points (bps) off GDP. The decline in spending reflects very weak real-wage and remuneration growth, weak employment, poor confidence and several years during which the fiscal burden on households has increased. Fixed investment, the critical driver of both future capacity and productivity, contracted by 4.5% q/q and has fallen for 10 of the last 13 quarters. Inventories also detracted, falling R11.6 billion in Q1-19. The final blow came from net exports, which fell by 7.5% q/q in Q1-19 as imports fell 4.8%, but exports collapsed by 26.4%.

Seen as a whole, the shape of South Africa's growth in Q1-19 echoes challenges faced by many other economies at this juncture; economic growth is the fragile balance between the health and resilience of domestic demand and the impact of external factors – falling trade volumes and rising uncertainty, and the subsequent knock-on to confidence.

However, unlike most of the world's advanced economies and a large proportion of emerging markets, domestic demand in South Africa has been alarmingly weak, dragging growth lower instead of providing a buffer. In fact, this is not new – South Africa has lagged global growth for more than a decade.

EMERGING MARKETS GDP: RELATIVE PERFORMANCE



Sources: IMF, Statistics South Africa

ONE THING LEADS TO ANOTHER

As we can now see very clearly, economic weakness isn't just about the economy growing slowly; it's also about weakness relative to other countries' economic performance. By growing more slowly than its peers, South Africa continues to fall behind. Both outcomes deliver fewer resources – slower absolute growth shrinks the pie, while relatively slower growth attracts less capital. This means that there are fewer resources at the disposal of both the private sector and the State, not only to stimulate further growth but also with which to address market failures, structural shortcomings, inequality and poverty.

There are several very dangerous features of economies that suffer extended periods of weak growth. First, the slow process of a decline is often not felt initially in everyday life; the consequences are only felt after a delay. In the first years, the economy can live off its capital, household and corporate balance sheets are in good health, and institutions are reasonably resilient. However, over time, weak growth triggers microeconomic decisions, such as delaying consumption, which exacerbate the downward spiral. This then leads to the second danger – that periods of growth weakness become reinforcing – and then, thirdly, that it becomes extremely difficult not only to stop the relative underperformance, but also to turn it around.

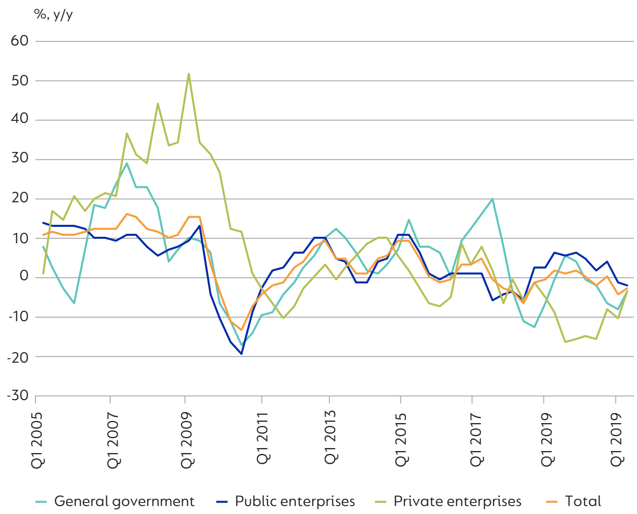
Periods of weak growth can be materially exacerbated by an increase in 'rent-seeking' behaviour among economic actors. Imagine a hypothetical economy where households have to choose one of two ways to obtain income: to engage in activities that produce goods and services that can be sold on the market or working for a salary (rent creation); or to seek a redistributive income, that is, to earn an income paid by the State or private institutions, financed by the work of other economic actors, without generating additional growth (rent seeking).

Through time, the more people who shift from productive to redistributive activity, the lower an economy's aggregate output becomes. For the unproductive, there is also increasing safety in this shift, because it becomes easier for them to hide. The economic cost of this shift from productive to extractive actors intensifies as the allocative distortions increase with the removal of resources from productive activities, and as innovation is lost. This becomes worse if rent seeking is institutionalised within the State. Rent-seeking societies prolong the weakness of growth and can lead to an insidious decline of an economy.

HOME TRUTHS

In South Africa's case, we now know that post-crisis economic weakness has been prolonged by a mal-allocation of resources that is first and foremost visible in both weak aggregate and weak relative growth. The protracted period of negative investment reflects the redistribution of resources away from productive activities and the loss of capacity in rent-creating entities. Pressure on households has increased and spending has suffered because of low income growth and rising unemployment, as well as the higher fiscal burden. Financially unviable and operationally dysfunctional state-owned enterprises (SOEs) are a further casualty of this process. The fiscal cost of this deterioration that has unfolded over the last decade is only now starting to be felt.

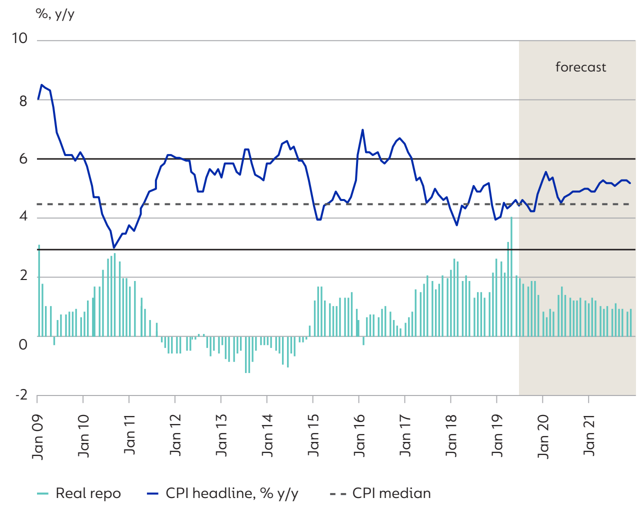
GROSS FIXED CAPITAL FORMATION BY SECTOR



Source: Statistics South Africa

Looking ahead, our base-case expectation is for a modest, cyclical improvement in growth. We expect employment to stabilise, and for a combination of less negative compensation growth and a small, ongoing increase in credit utilisation to allow household spending to grow at 1.5% year on year (y/y) in real terms. At this stage, we do not expect fixed investment to grow, but we should see some moderation in the extreme contraction of the past three years and possibly some normalisation in inventory levels. We forecast GDP growth this year of 0.7%, and a still-weak 1.5% in 2020. Inflation within this very weak context remains subdued, with average headline CPI forecast at 4.4% in 2019 and 5.0% in 2020. We expect the central bank to provide some monetary support for growth, and we anticipate 50bps in rate cuts this year, with the first 25bp reduction announced at the 18 July Monetary Policy Committee meeting.

CPI AND REAL RATES



Source: Statistics South Africa

On the downside, the economy remains hostage to what is now a long period of growth weakness and the negative consequences of the redirection of resource allocation over the last 10 years. This is most immediately visible in the need to provide financial support for SOEs, notably Eskom. Despite National Treasury allocating R23 billion per annum for the next 10 years in additional funding for Eskom in this year's National Budget, it has become increasingly clear that more will be needed, and sooner. Details remain unclear, but ensuring financial stability for Eskom will invariably add debt to government's already strained balance sheet, increasing the annual deficit and incurring additional financing costs.

We expect debt-to-GDP to exceed 60% in the current fiscal year and to escalate over the medium term. The pace of debt accumulation will depend heavily on the ability of the economy to move from low growth to a sustainable recovery. This, in turn, requires a dedicated enforcement of rent-creating policy implementation and practice to rehabilitate the long period of decline. ✚

Are you not entertained?

How sports content (and fast cars) became frontrunners in the media content race

By John Parathyras

THE REALISATION THAT people attach a great deal of importance to being entertained is not a new one. One of the earliest observations dates back to first-century Rome, when the poet Juvenal decried the 'bread and circuses' used by government to pacify and distract the common man as he was slowly robbed of his democracy. In those days, the 'circuses' were the extravagant games put on in coliseums featuring violent, sometimes fatal, bouts between gladiators. Thankfully, much has changed since the days of Ancient Rome, but one thing that has endured is our collective love of being entertained – humans have always loved stories and escapism.

What has, however, changed dramatically over the intervening centuries is the media we use to consume those stories, particularly over the past 100 years or so. That change has not

John is a global developed markets analyst with seven years of investment experience.

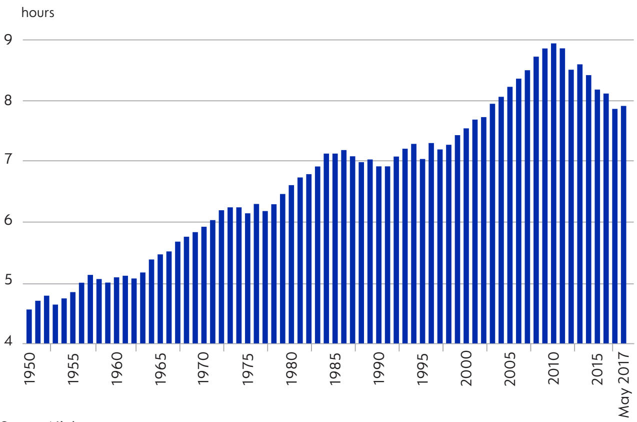
been a steady and cumulative force; rather, there have been long periods of relative stability punctuated by the arrival of a new technology that subsequently disrupted and radically reshaped consumption habits. The arrival of newspapers in the 1700s, cinema and radio in the early 1900s, TV in the 1920s and cable TV in the 1950s all fundamentally changed the media landscape.

For many decades and the entire latter half of the 20th century, TV was a dominant and pervasive form of entertainment. The amount of time the average American household spent watching TV steadily increased after its mass adoption after World War II, reaching a peak of almost nine hours per day in around 2010. Since then, this number has been declining.

WHAT HAS CHANGED?

How we consume our entertainment is undergoing another tectonic shift, this time brought about by the advent of the internet in the 1990s and the smartphone in the 2000s. This was accelerated by the spread of broadband access and the consequent dramatic decline in the cost of downloading data and rapid rise in download speeds.

HOURS OF TV AMERICAN HOUSEHOLDS WATCH PER DAY



Source: Nielsen

Consumers today now enjoy a near tyranny of choice when it comes to how to entertain themselves. The fact that traditional TV viewership is declining does not mean that those missing hours are not being spent on entertainment, but there has been a shift in how people are choosing to allocate their entertainment hours.

Estimates vary, but the average American adult spends more than three hours per day using a smartphone, double the amount of time spent a decade ago. A large proportion of this is spent on web browsing, social media, games or other forms of non-video content. But much is also being allocated to the likes of YouTube, Netflix and other providers of on-demand video content.

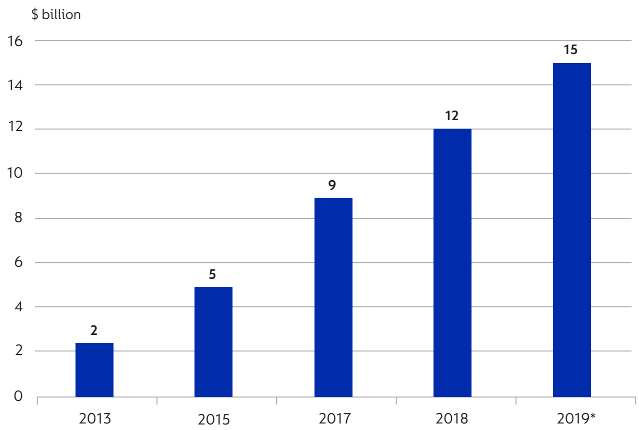
THE RACE FOR VIEWERS

The net effect is that the consumption of video entertainment in the US is not declining, but growing. And it is also growing strongly globally. A recent white paper by Cisco (a US maker of IT hardware used to transmit data over computer networks) estimated that global internet traffic has grown by 23 times over the past decade and will triple by 2022. By then, over 80% of this data is likely to be in the form of video content (up from 75% in 2017) and half will be consumed on smartphones and tablets (up from 23% in 2017).

What does this all mean? The global media landscape is shifting dramatically, given the changes in consumer viewing habits that are being enabled by new technology and new players. The creators of video content and the traditional pay-TV distributors of that content are facing increasing competition for eyeballs (as well as so-called 'cord-cutting' from consumers cancelling their service) from new 'over-the-top' (OTT) players like Netflix, Apple TV, Amazon Prime Video and Hulu that offer video-on-demand (VOD) over the internet.

But these new players now find themselves in a content 'arms race' and they are spending vast sums of money on creating new video content to establish a beachhead in this new world. Netflix is expected to spend $15 billion this year on original video content, up from only $2 billion six years ago; Apple is aiming to spend at least $1 billion on original content ahead of launching its own OTT service; and Amazon is likely to spend $7 billion this year, up from $5 billion last year.

VIDEO CONTENT BUDGET OF NETFLIX WORLDWIDE



* statista.com states that "Wall Street analysts see [the] $12.04 billion figure climbing 25% – to around $15 billion on a gross cash basis" in 2019. Figures prior to 2017 and 2018, and forecasts for 2019 come from an earlier article.

Sources: eMarketer, JPMorgan Chase, IHS, Netflix, Business Insider, Statista, FierceCable, Variety

All of this is great for consumers who now have more choice of what to watch (the number of scripted TV shows in the US has more than doubled since 2010), where to watch it (on TV, internet-enabled TV, smartphone or tablet) and when to watch it. This last point is worth noting for an important reason: the rise of video streaming over the internet intensifies what the pay-TV distributors started years ago with the introduction of VOD technology, namely a reduction in the proportion of TV that is watched live. This means that viewers are now less likely to sit through advertisements, which makes video content less attractive to advertisers.

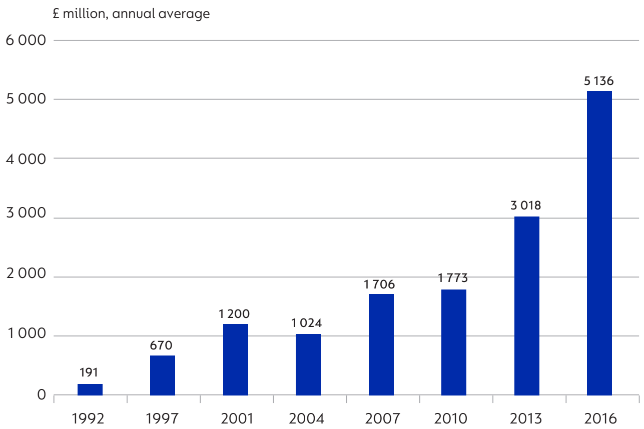
NOT ALL CONTENT IS EQUAL

There is an adage in the media industry that 'content is king'. But this proliferation of original video content available on-demand makes it more challenging for content creators and distributors to capture large audiences and monetise their content. There is one notable exception, however: sports content is hugely valuable and becoming increasingly so.

In the US, the fee that pay-TV distributors are charged by ESPN (the largest sports channel) to include it in their offering is around four times that of the next highest fee channel. And channels like ESPN pay sports leagues increasingly large amounts of money for the rights to broadcast their games. For example, National Football League (NFL) broadcast rights have risen by roughly five times over the past two decades (well ahead of nominal GDP growth).

This is not only a US phenomenon: the domestic broadcast rights for the English Premier League have risen by 27 times in 25 years, and the tech giants are also starting to compete aggressively for sports rights. Last year, Amazon renewed a deal with the NFL for the rights to stream 11 of its games for $65 million per year – 30% more than Amazon paid for the same rights in the previous season, driven by fierce competition from its rivals Twitter and YouTube, and almost seven times what Twitter paid for these rights in 2016.

PREMIER LEAGUE TV DOMESTIC BROADCASTING RIGHTS REVENUE

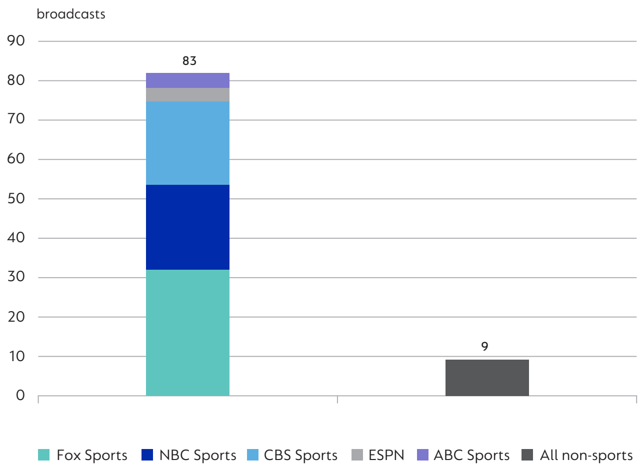


Source: BBC

Sports content is attractive for a few reasons. The first is that people (increasingly) love watching sports. In 1998, 25% of the top 100 traditional TV broadcasts in the US were sports events; in 2018 this figure grew to 88%. Second, at the risk of stating the obvious, no new major sports are being invented. Unlike other forms of entertainment, such as TV shows or movies, someone cannot set up a new sport and churn out content to compete with existing sports. Third, most of the world's big sports have well-established leagues and it is nearly impossible to start a new league that can compete.

This means that the supply of sports content has constraints and is relatively limited versus most other forms of content. Finally, most sports are watched live: sports are viewed live more than 95% of the time versus less than 50% for regular non-sports traditional TV content. What this boils down to is that sports draw large, live audiences who are willing to pay to view them, and thus are highly engaged, making sporting events attractive to advertisers. This is certainly a compelling option in an increasingly fragmented and competitive media landscape. As investors, it would be great if we could capitalise on this.

US TV BROADCASTS DELIVERING 20 MILLION+ VIEWERS IN 2017/2018



Source: Nielsen

THE FORMULA FOR SUCCESS?

Unfortunately, there are few options available to investors in public markets to invest in sports content. There are a few publicly listed football teams such as Manchester United and Juventus, but the real owners of sports content (and hence the broadcast rights to that content) are the leagues themselves; there is a limited number of global sports leagues and even fewer that are directly investable. For example, one cannot buy shares in the FIFA World Cup or the Olympics, as they are not listed or private entities, but rather not-for profit organisations. However, fairly recently, one truly global sport has been listed and is now investable: Formula One (F1).

1950
ESTABLISHED

10
TEAMS

20+
RACES

500m
UNIQUE VIEWERS

200
TERRITORIES

In January 2017, Liberty Media Corporation acquired 100% ownership of the then privately owned parent company of the F1 Group, which holds the commercial rights to the sport of F1 for the next 90-odd years. The F1 Group was subsequently listed and now trades on the US stock market. F1 is the premier global motorsport series, with a long history and almost 500 million unique viewers in nearly 200 territories watching 10 teams fight it out in around 20 races across five continents every year. F1 is arguably the only global sports league or event other than the Olympics and the FIFA World Cup, but a noteworthy difference is that, unlike the Olympics and the World Cup, F1 happens every year.

PRICED OUT

F1 makes most of its money from broadcasting rights and the fees it collects from race hosts (each roughly one third of its revenue), with the rest coming from sponsorship deals, merchandising, licensing its intellectual property and a few other smaller items. On the cost side, F1's largest cost of doing business is by far the roughly half of its revenue that it pays to the race teams. Fielding an F1 race team is horrendously expensive – there are no budget caps in the sport and so there is an incentive to spend as much as possible to create the fastest car possible to improve one's chances of winning.

A mid-tier race team is estimated to spend roughly $150 million per season, while top teams like Ferrari and Mercedes likely spend as much as three times that amount. This means that despite the F1 league paying $1 billion of its revenue over to the race teams every year, most, if not all, teams are loss-making. The high cost of competing makes many teams unsustainable (since the first F1 race in 1950, over 150 race teams have come and gone), deters even large automakers from entering the sport and can make for duller racing on the track as deep-pocketed teams simply outspend the rest of the field.

DRIVING EFFICIENCY

There is reason to be optimistic that the new managers of F1 can better monetise the sport and, potentially, reduce how much revenue flows to the teams. For example, on a per-viewer basis, F1 earns $1 in broadcast rights for every $5 the NFL makes and every $3 the English Premier League earns. There is also room for improvement on sponsorships: when Liberty took over, only 13 of the races had title sponsors and F1 had only nine official partners (versus 47 for the PGA, 34 for the Olympics and 33 for the NFL).

On the cost side, although perhaps easier said than done, if Liberty can successfully negotiate better cost controls, it will improve team economics, increase how much profit it can retain, and possibly even make for a better racing spectacle by creating a more level playing field. Liberty is currently in negotiations with the race teams to make this happen and has some capable people in its ranks working on it.

Beyond this, Liberty is focused on growing awareness of the sport, including a recent 10-episode Netflix documentary and investing in an F1 esports series. After declining in recent years, F1's global viewership rose by 10% last year. A standalone F1 OTT product is also being rolled out to monetise hardcore fans.

F1 is a very rare and iconic asset, and one of the most watched events on the planet. As an investment, it is a way to capitalise on the heightened competitive environment and demand for sports content discussed above, while also offering levers that can be pulled by F1's management to improve the sport and strongly grow its revenue and profits. We recently took a position in the F1 Group in our Global Equity Strategy on behalf of our clients. Like the Ancient Romans did with theirs, we will be watching the F1 circus closely. +

The luxury goods love affair

When desirability becomes necessity

By Lisa Haakman

YOU'RE 25, AND you spot an object of desire across the room. You ask around, find out their name, and then set out to do some research on them. You stalk them on every available social media platform – check how many mutual friends you have on Facebook and see how many followers they have on Instagram – verifying their 'desirability'. Having established their suitability as a partner, you express some interest.

So the courtship begins. They woo you at every turn ... invitations to prestigious events, flowing champagne, playful flirting, subtle compliments and charm. They seem to know exactly what you like. What began as infatuation evolves into falling in love. It's exhilarating, you're obsessed. They're all you can think about. You begin planning a future together, you picture them on your arm forever.

Lisa is an equity analyst with 13 years of investment experience.

Not your future marital partner, but a Hermès Birkin bag. Or a Chanel 2.55. Or a Lady Dior. All of them are classic enough to be on your arm forever. In fact, Louis Vuitton still sells two bags it designed in the 1930s, the Keepall and the Noé.

LOUIS VUITTON KEEPALL

LOUIS VUITTON NOÉ

The relationship between a consumer and a luxury goods company can ebb and flow and, much like the dating game, the rules are changing in this increasingly digital world. Many of the luxury companies are struggling to keep apace, while others are thriving in this new paradigm.

FOREVER LOVE

Our work on the luxury sector has identified a number of key tenets to ensuring a lasting romance:

Luxury companies are clearly polygamists but need to create the illusion of being in a monogamous relationship with you. This is the largest conundrum for luxury companies; creating and maintaining perceived exclusivity while still selling millions of products each year. It is a very fine balancing act between growth and ubiquity, and brands that grow too quickly run the risk of losing brand cachet and desirability. Successful brands such as Louis Vuitton and Hermès have achieved this by continually putting through price increases rather than increasing volume, increasing product ranges, launching exclusive capsule collections with known artists and celebrities, and expanding product categories into areas such as luggage, accessories, beauty, perfume and cosmetics.

Luxury companies must never devalue your relationship. Many luxury companies sell entry-priced items but manage to do so without devaluing their core brand. Selling entry-priced items is important in courting 'new-to-luxury' customers and serves to reduce the cyclicality of the business. But doing so without devaluing the brand is a balancing act. Brands achieve this by only ever advertising their most expensive products. This has the additional positive outcome that when a consumer finds a less expensive item, they feel like they are getting a bargain, perhaps even a mispriced item. In addition, brands ensure that entry-priced items are never readily available. There is often a lengthy waiting list, such as for the Rolex Submariner Hulk.

Luxury companies must never undersell themselves. Louis Vuitton is famous for saying they would rather incinerate unsold products than sell them at a discount. Luxury brands have all come to realise this is the correct strategy, but many have opted still to have specific outlet stores which sell the off-price items, minimising the impact to the brand while still allowing them to clear unwanted inventory. Christian Louboutin, Hermès, Tiffany and Louis Vuitton are four brands that have zero promotions and no outlet stores either, cementing the strength of their brands and serving as an aspiration for peers.

PROPORTION OF OUTLET STORES IN THE STORE BASE

Brand	Full-price stores	Outlets	Ratio
Michael Kors	760	114	6.7
Coach	859	127	6.8
Ermenegildo Zegna	482	60	8.0
Valentino	272	31	8.8
Alexander McQueen	74	8	9.3
Tod's	268	27	9.9
Versace	339	34	10.0
Saint Laurent	242	24	10.1
Gucci	594	58	10.2
Dolce & Gabbana	313	29	10.8
Loro Piana	167	15	11.1
Burberry	486	43	11.3
Salvatore Ferragamo	366	29	12.6
Givenchy	129	9	14.3
Moncler	224	15	14.9
Prada	420	25	16.8
Armani	2 070	92	22.5
Miu Miu	185	7	26.4
Bottega Veneta	344	12	28.7
Celine	209	7	29.9
Balenciaga	181	6	30.2
Bulgari	322	10	32.2
Christian Louboutin	147	0	n/a
Hermès	315	0	n/a
Louis Vuitton	490	0	n/a
Tiffany	480	0	n/a

Sources: RE Analytics, Bernstein Analysis

Luxury companies must get to know you and control the path of the relationship. Luxury brands that sell wholesale and rely on third-party companies to sell to the end-consumer are not in control of their own destiny. They cannot get to know their customer, are not in control of the customer experience and run the risk that the end-customer winds up loyal to the third party rather than to the brand.

The truly successful brands are those that sell 100% retail, own all their own stores and operate their own ecommerce sites, or operate via a concession on an e-tailer. This allows them to build up knowledge of their client in order to generate personalised recommendations and utilise the data to drive revenue.

PROPORTION OF SALES VIA WHOLESALERS

Brand	Wholesale
Armani	70%
Coach	62%
Christian Louboutin	60%
Alexander McQueen	49%
Balenciaga	49%
Ermenegildo Zegna	45%
Salvatore Ferragamo	41%
Moncler	37%
Michael Kors	35%
Saint Laurent	32%
Loro Piana	32%
Givenchy	32%
Celine	32%
Bulgari	32%
Tod's	30%
Versace	27%
Dolce & Gabbana	20%
Burberry	20%
Prada	18%
Miu Miu	18%
Bottega Veneta	18%
Gucci	15%
Hermès	15%
Valentino	12%
Louis Vuitton	0%
Tiffany	0%

Sources: RE Analytics, Bernstein Analysis

Luxury companies must ensure you continue to feel special. Luxury companies can achieve this with specialised treatment for their VIP customers, as well as through exclusive offers. Many luxury brands invite their most important customers to exclusive events and fashion shows. Louis Vuitton offered its Supreme/Louis Vuitton capsule to VIP customers on an invitation-only basis.

Luxury companies must relentlessly maintain their beauty. Luxury companies need to invest continuously in their store network, their creativity and their marketing. Stores are expressions of art, style and beauty – they need to provide an experience, not just a clothing rail, and need to be continually revamped. Creative directors need to keep designs fresh and unique, and marketing directors need to keep the brands alive and relevant.

Luxury companies must be good at social media. Social media likes, comments and followers are becoming increasingly important in creating brand desirability. Chinese consumers and millennials are becoming bigger luxury consumers, and they are often digitally native consumers. Many luxury goods companies are currently launching Instagram click-through sales and this channel looks set to become increasingly important. Kering is currently the leader in embracing digital, with Gucci the largest-selling online brand.

In an increasingly narcissistic world, luxury goods companies are thriving. Their products allow consumers to look and feel better about themselves by owning an item which they perceive as special and exclusive. Even better, they can Instagram themselves, earning kudos and credibility in an increasingly superficial world.

ATTRACTIVE IN MORE WAYS THAN ONE

Luxury companies are better businesses than we at first appreciated. This is for a number of reasons:

There are a finite number of brands. The majority of the truly successful brands have two things in common – heritage and provenance. One of the things required for a luxury brand to gain legitimacy is time. Relatively 'new' brands such as Dior, Saint Laurent and Ferragamo are more than 50 years old. Gucci, Fendi, Loro Piana and Prada are over 100 years old, and Hermès, Cartier, Louis Vuitton and Burberry are more than 200 years old. Provenance is equally important. With only a few exceptions, such as Burberry in the UK or Loewe in Spain, nearly all of the luxury houses are either Italian or French. As a result, it is highly unlikely that new brands or new competitors would spring up overnight.

Barriers to entry are high, especially with the demise of department stores. A certain level of scale is required in order to afford a very expensive store network located in prime retail locations, an ecommerce platform and expensive marketing. This has raised barriers to entry for newcomers.

Pricing power and exponential price relative to quality. Brands are able to charge exponentially higher prices for slightly higher quality items. This enables luxury goods companies to deliver extremely high margins and high returns on capital, compounding returns for shareholders.

Excellent cash flow generation. Many of the luxury goods companies are excellent cash flow generators, converting c. 90% of earnings to cash.

Luxury goods companies with strong portfolios of brands are relatively defensive. The LVMH Moët Hennessy Louis Vuitton (LVMH) portfolio of brands is both geographically and divisionally diversified, creating a defensive portfolio. In 2009, revenue declined by only 0.8% while operating income fell by only 7.6%, an admirable achievement during the Global Financial Crisis.

As a result, we believe luxury companies are far better businesses than often perceived. In our view, they are among the best businesses in the world.

We particularly like those luxury companies that are run by astute management teams with large shareholdings in their personal capacities, such as LVMH, owned by the Arnault family and Kering, owned by the Pinault family. Both businesses have generated significant returns for shareholders over all meaningful time periods, and we look forward to long and lasting relationships with both of them. ✚

GLOBAL ECONOMY

Global chill

World economy balancing on regional tensions and precarious geopolitical alliances

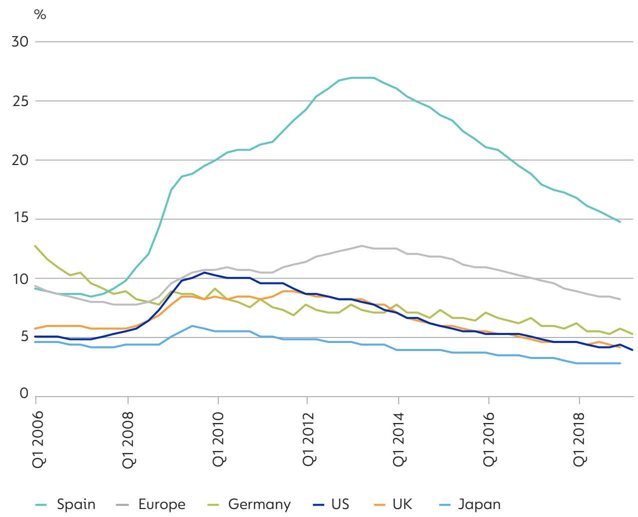
By Marie Antelme

IT'S HARD TO judge whether global growth is bottoming out, or on the brink of a sharper, more aggressive moderation. After slowing for most of 2018 and into the first quarter of 2019 (Q1-19), global growth momentum seemed to be showing signs of stabilising early in the second quarter (Q2-19). Activity indicators remain mixed but, in general, developed economies continue to benefit from durable domestic demand, underpinned by tight labour markets with low unemployment and positive real wage growth and, in some cases, more supportive fiscal policies. This source of resilience is, however, increasingly challenged by a considerably weaker external environment, broadly reflecting a combination of weak Chinese economic activity, the escalation in trade tensions globally (not limited to the US and China) and the ever-increasing associated uncertainty that threatens to undermine domestic demand.

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

The outlook for global growth for the remainder of the year and into 2020 will depend on the balance of these two forces – can domestic demand and supportive monetary and fiscal policies offset the drag on growth that weak global trade and pervasive uncertainty exert?

GLOBAL UNEMPLOYMENT RATE BY COUNTRY



Source: Datastream

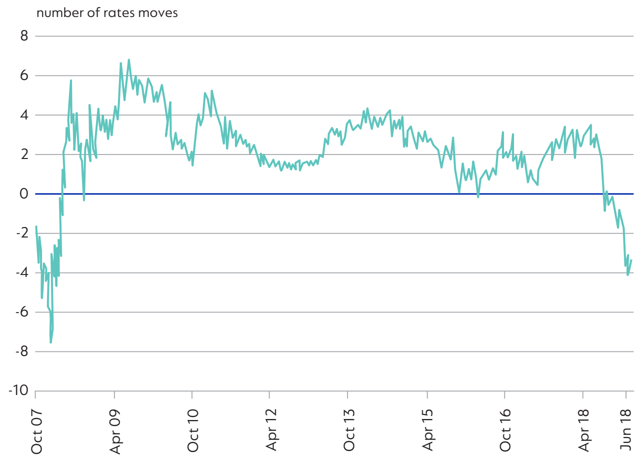
In the face of weaker activity data, global central banks have committed to ongoing monetary support. The clearest message has come from the European Central Bank (ECB), which has not only guided that the policy rate will remain low well into 2020 but has also announced an extension of its quantitative easing programme.

The US Federal Reserve's (Fed) communication turned more dovish early this year (after having hiked the policy rate 25 basis points [bps] to 2.5% in December 2018), but recent policy meeting minutes suggest actual easing is in fact imminent. Consensus expectations have built for a 25bps to 50bps cut at the July Federal Open Market Committee meeting, while the market pricing is for aggressive easing of a full 100bps over the next year.

In Europe, ECB policy rate guidance appears to be in line with what is becoming a more prolonged period of European growth weakness. As trade comprises a large proportion of Europe's GDP, especially in countries such as Germany, and supply chains are highly integrated, the region is more broadly exposed to trade tensions.

The outlook at this stage for US interest rates is less clear, given more mixed domestic data, particularly in the case of recent employment and investment indicators. Global risk assets have nonetheless been well supported by falling rate expectations, and we expect this dynamic to remain in play for now, as growth remains soft in larger developed economies, with downside risk.

MARKET PRICING OF FED CUTS



Source: Morgan Stanley

TRADE TENSIONS REMAIN CENTRE STAGE

Looking ahead, the suspension of planned tariff increases agreed to at the G20 Summit in Osaka in June has provided some temporary relief and pushed out the more immediate and damaging risk that would have been posed had they come into effect now.

The economic impact of trade wars is addressed by Professor Eichengreen in the cover article on page 5, but it is nonetheless pertinent to mention here too. The tariff increases implemented since early 2018 have raised the weighted-average US tariff from c. 1.8% to 4.5%. While the next step would have elevated this significantly, the tariff increases alone have already diverted traditional trading arrangements, disrupted supply chains, raised the cost of intermediate goods (as well as some end-products) and are more likely in the short term to have undermined new activity supporting orders and longer term, investment plans. In addition, the ancillary effect of tighter financial market conditions compounds the economic impact and will continue to do so as issues arise, as we expect them to, over time.

The US economy has been relatively resilient through this period of rising uncertainty. GDP growth accelerated in Q1-19 to 3.1% quarter on quarter, seasonally adjusted and annualised (q/q, saa), from 2.9% in 2018, despite higher policy rates. Strong inventory building contributed positively to growth, with a solid underpin from consumer spending and relatively good capital formation, outside of housing. Net trade benefited from lower intermediate goods imports (reflecting higher tariffs). Despite some weaker data which followed in Q2-19, including a weak jobs report for May, most recently available data point to healthy employment gains, stronger housing activity and healthy durable goods orders. US GDP growth is expected to moderate to about 2.7% in 2019 from 2.9% in 2018, and to trend at about 2% in 2020.

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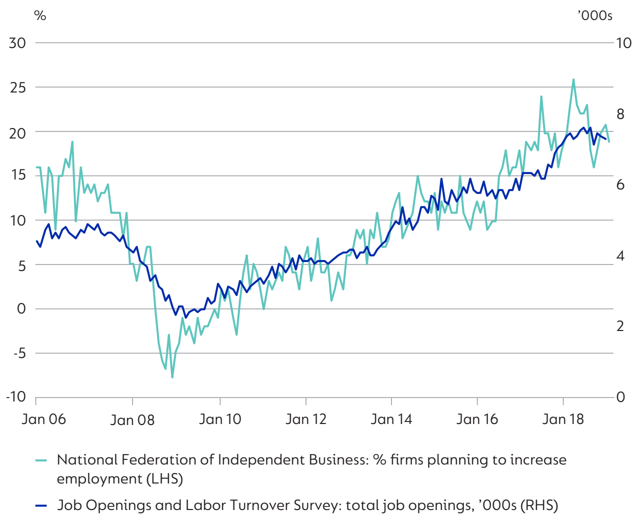
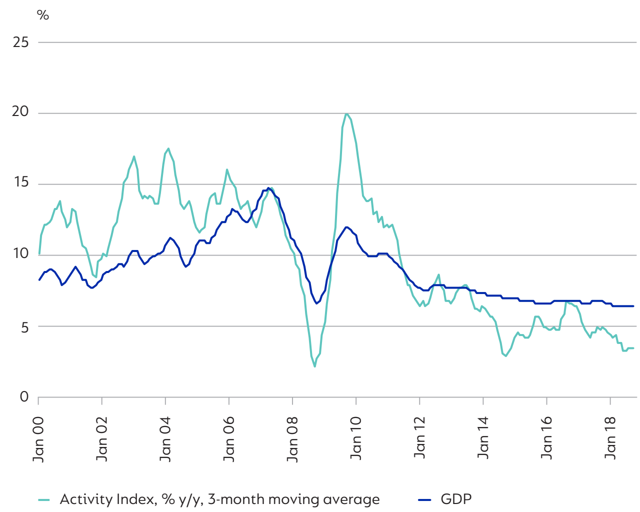
US LABOUR MARKET TIGHTNESS



Source: Datastream

CHINESE ACTIVITY VERSUS GDP



Source: Emerging Advisors Group

European growth has suffered both idiosyncratic shocks and a general drag from weaker global trade. Germany, Europe's largest economy, suffered a contraction in growth in Q3-18 as new emissions regulations disrupted motor and other manufacturing activity. This was compounded by weak growth out of China and the general deterioration in global trade volumes. With strong supply chain links to broader Europe, GDP growth was 1.6% q/q, saa in Q1-19, from 1.8% in 2018. Strong labour markets have been a solid support of consumer spending, but some cracks are emerging. Where the services sectors have shown strong growth and relatively little impact from weak trade (which has severely impacted manufacturing), forward-looking indicators have deteriorated, and some labour indicators are less strong. Broadly, growth expectations have been revised lower as trade uncertainty persists and risks of a broader economic contagion increase.

The UK economy, after a period of relative resilience despite the messy Brexit process, is now also showing stronger signs of slowing. GDP growth was 1.9% q/q, saa in Q1-19, from 1.4% in Q4-18, but is expected to slow to 1.2% by 2020. Politics will continue to dominate economic outcomes in the UK. Following the resignation of Prime Minister Theresa May, the Conservative Party must now elect a new leader to navigate an increasingly chaotic Brexit process, with Boris Johnson currently the front-running candidate. Mr Johnson's seeming willingness to deliver a no-deal Brexit should new terms not be agreed is a meaningful threat to UK growth. At this time, it is hard to see what political agreement can possibly be reached, given the actors involved, and even less likely that the EU will be open to further negotiations under new UK leadership.

GDP growth in China remains subdued, hostage to the changeable and fraught trade negotiation process. Chinese policymakers have intervened to bolster demand by cutting the reserve requirement ratio 350bps since March 2018, in an increasingly responsive manner. Total tax and fee cuts amounting to an estimated 2% of GDP have also started to be implemented, and there has been an acceleration in both credit availability and social funding. Official GDP growth was 6.4% in Q1-19, from 6.6% in Q4-18, but most activity data remain well below this. While activity is no longer slowing, for now there seems little evidence that interventions have helped boost demand yet.

Given the ongoing economic impact of the prolonged period of credit tightening which started in 2017, we expect the Chinese economy to continue to grow slowly through 2020. Elsewhere in emerging markets, the impact of higher tariffs and the threat of further escalation remains a drag on growth. Some improvement in GDP growth in Turkey and Argentina after recessions in 2018 helped lift the aggregate, but the external risk is likely to remain a dominant drag on growth.

In closing, an ongoing, escalating risk to global economic outcomes is the loosening of traditional geopolitical alliances and an escalation in regional tensions, any number of which could have a significant impact on markets in coming months. The recent intensification of hostility between the US and Iran is almost certainly not over, but the longer game remains the strategic tension between the US and China, which we expect will continue for the foreseeable future. +

The grass is not always greener

Offshore acquisitions by domestic companies

By Quinton Ivan

"I'm no genius, but I'm smart in spots, and I stay around those spots." – Tom Watson Snr, founder of IBM

WARREN BUFFETT FREQUENTLY uses the concept of the 'circle of competence' in his letters to Berkshire Hathaway shareholders to illustrate the importance of staying focused. This applies equally to capital allocation decisions in a business. Despite building formidable businesses and raising the barriers to entry for new entrants during years of operating in a closed, domestic economy pre-1994, there is a preoccupation among many South African management teams that the grass is greener elsewhere. This has led many domestic companies to expand offshore, usually by acquisition, the majority of which have had disastrous consequences for shareholders.

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

There is the odd success story, but they are the exception rather than the rule. Offshore acquisitions by domestic companies have been pervasive across sectors – as an example, virtually every major South African life insurer and commercial bank has acquired a business outside of South Africa. Of the numerous examples in our market, two of the larger transactions recently undertaken are interesting case studies.

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ACQUISITION OF DAVID JONES BY WOOLWORTHS HOLDINGS

Woolworths Holdings announced in April 2014 that it would pay R21.4 billion (A$2.1 billion) for David Jones, the iconic Australian department store. David Jones services the more affluent Australian consumer through a network of 38 stores, four of which it owned, including the flagship department stores in Sydney and Melbourne. This was a sizeable transaction, comprising nearly a third of Woolworths' market capitalisation at the time, and valued David Jones at a 21 times price earnings multiple based on its last reported earnings.

Fundamentals in place

While South African retailers have a dismal track record in acquiring businesses in Australia – most notably Pick n Pay's failed acquisition of Franklins and Truworths International's unsuccessful foray with Sportsgirl – investors were prepared to back Woolworths CEO Ian Moir.

Moir was appointed CEO in November 2010 after successfully turning around Country Road, another Australian retailer acquired by Woolworths in 1998. Up until the acquisition of David Jones, Moir had an enviable track record – Group revenue and profits grew strongly during his tenure, compounding at 14% and 23% per annum, respectively. Although department stores have come under threat globally, losing market share to specialist and online retailers, the rationale for acquiring David Jones sounded compelling:

- It had been undermanaged for several years and basic retail discipline had slipped, which was evident in its steadily declining trading densities.
- Underinvestment in IT systems and poor processes meant that it lagged its peers in online retail, lacked a compelling loyalty programme and had a poor omnichannel offering.
- Private label product was nonexistent (only 3.5% of revenue) and there was an opportunity to improve operating margins and profitability by selling more David Jones and Woolworths brands through its store network.
- There were significant scale benefits that would allow the enlarged Group to leverage its buying power and design capabilities, which would improve price efficiency. This would allow Woolworths to strengthen its southern hemisphere platform as a defence against northern hemisphere entrants such as H&M and Zara, both in South Africa and Australia.

The net result of these initiatives was an expected uplift of between A$130 million and A$170 million per annum in incremental earnings within the next five years. This was significant in the context of David Jones having generated A$143 million operating profit at the time of acquisition.

VALUE CREATION OPPORTUNITIES IN EXCESS OF ~R1.4 BILLION PER ANNUM WITHIN 5 YEARS

		EBIT impact	Timing of benefits
1	Introduction of Woolworths Holdings private label	A$70m - A$80m	FY15E - FY17E
2	Growth of Country Road Group concession brands	A$30m - A$40m	FY15E - FY17E
3	Introduction of David Jones loyalty scheme	Nil assumed	FY16E - FY18E
4	Enhance omnichannel performance	Nil assumed	FY15E - FY19E
5	Optimise Group real estate portfolio	A$20m - A$30m	FY17E - FY19E
6	Improved margin through Group sourcing strategy	A$10m - A$20m	FY16E - FY19E
	Total	~A$130 million	

Source: Woolworths roadshow presentation: acquisition of David Jones, 9-10 May 2014

This target was described as 'conservative' by Woolworths, indicating its confidence in extracting these synergies, thereby justifying the high price paid. Initially, this confidence was vindicated as profitability improved at David Jones. Woolworths appeared to be executing flawlessly and seemed to uncover further opportunities to enhance value, including launching a fresh and prepared foods business in Australia.

David Jones grew sales ahead of the market, gaining market share from its major competitor, Myer. Margins expanded and nearly a fifth of the purchase price was recouped when it sold its Market Street property in Sydney to the Scentre Group for A$360 million.

These proceeds would be used to fund its capital expenditure programme, including the implementation of new IT and finance systems, relocating its head office to join that of Country Road in Melbourne, refurbishing its flagship Elizabeth Street store, and trialling its food concept.

Conditions deteriorated

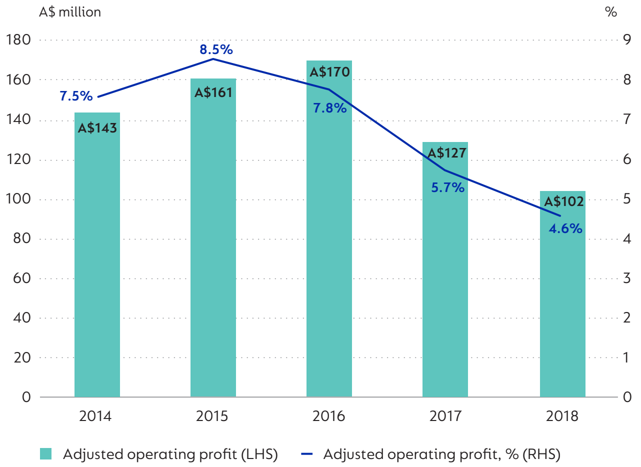
All appeared to be going according to plan, until trading took a turn for the worse in 2017, due to the following factors:

- The Australian retail environment deteriorated as discretionary spend came under pressure, exacerbated by high levels of consumer indebtedness. This resulted in heavy discounting as retailers competed aggressively for market share, leading to pressure on both revenue growth and gross margins.
- The introduction of private label product failed to resonate with the David Jones consumer. This was a significant setback, as it was anticipated that this move would generate around half of the synergies announced at the time of acquisition.

- The deterioration in financial performance resulted in several management changes within a short period of time. As a result, Moir and other South African managers were forced to become increasingly involved in the daily running of David Jones. This was at the expense of the South African operations, which were also experiencing a highly competitive retail environment and a declining economy.

- These setbacks occurred during a period when David Jones was implementing various transformative projects, such as the Elizabeth Street refurbishment, investment in an omnichannel and loyalty programme, new merchandising and finance systems, head office relocation, and a food concept trial. The associated implementation costs further reduced profitability.

DAVID JONES' PROFITABILITY TRAJECTORY SINCE BEING ACQUIRED BY WOOLWORTHS



Sources: Woolworths results presentation, Coronation analysis

The above graph shows how profitability grew during the first two years post-acquisition, reaching a peak of A$170 million before collapsing and eventually troughing at A$102 million – a decline of 29% since acquisition and 40% from the peak.

This decline weighed heavily on Woolworths' investment in David Jones and culminated in an impairment charge of A$712.5 million (R6.9 billion) taken in January 2018, effectively writing off a third of its initial investment.

Transformation push

Woolworths' transformative initiatives appear sound – a similar strategy has been adopted by successful department stores elsewhere in the world such as John Lewis, Selfridges and Bon Marche – and should enable David Jones to compete more effectively against online and specialist retailers, and to address the impact of undermanagement.

While Woolworths may be able to extract some value from David Jones in the short term, there is a significant risk that it has acquired a 'melting ice cube' – department stores globally are increasingly under threat from online retailers and changing consumer shopping patterns. It is possible that it will continue to lose relevance over time.

This would be a disappointing outcome for shareholders, not only in terms of the potential value at risk, but also the significant management distraction away from the core South African operations. It will become evident over the next 18 months which way this investment is panning out.

SASOL'S LAKE CHARLES CHEMICALS PROJECT

In late 2012, Sasol announced that it was progressing the front-end engineering and design of the Lake Charles Chemicals Project (LCCP), an ethane cracker and gas-to-liquids (GTL) project in Lake Charles, Louisiana, on the Gulf of Mexico.

The advent of the US shale industry meant that it would have surplus natural gas, including ethane and methane gas. An ethane cracker uses ethane gas, and processes or 'cracks' it into ethylene and other derivative products. A GTL plant uses a refinery process to convert methane gas into longer-chain hydrocarbons, such as diesel.

The prices of these finished products are determined relative to the oil price. Effectively, the LCCP was looking to exploit the price differential between cheap feedstock (due to a surplus of natural gas caused by the booming shale industry) and a high oil price.

In October 2014, Sasol announced the final approval for the LCCP, with beneficial operation expected to begin in 2018.

The total expected cost of approximately $8.9 billion, c. 27% of Sasol's market capitalisation at the time, was roughly $3 billion to $4 billion higher than comparable ethane cracker projects being constructed in the region by peers such as Dow Chemical Company and Chevron Phillips Chemical Company. Sasol justified this differential due to:

- Competitors already having considerable polyethylene infrastructure in place.
- Differing downstream chemical derivative configurations – Sasol would have a greater mix of higher valued finished products.
- The LCCP also included some capital expenditure in respect of the GTL plant.

Despite the significant project cost, Sasol's management was confident that the LCCP investment case was sound and ticked all the necessary boxes.

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SASOL'S INVESTMENT CRITERIA UNDERPIN A SOUND BUSINESS CASE

	Robust project economics
Technology	Do we have a technology, scale of plant or operating know-how that provides a competitive advantage?
Feedstock	Do we have a leading low-cost feedstock?
Market	Do we have a product or market position that provides us with a compelling business case?
Capability	Do we have the required project execution capability to execute the project within schedule and on budget?
Financing	Do we have access to adequate funding while maintaining our targeted gearing and progressive dividend policy?

Source: Sasol LCCP investor presentation

Stress test

The economics of the LCCP were initially based on the following key assumptions:

- A long-term real oil price of around $100 per barrel and stress tested at $90 per barrel.
- A long-term Henry Hub gas price of $3 to $4 per metric million British thermal unit.

Based on these assumptions, Sasol was confident that the case for LCCP was robust and it was expected to exceed its hurdle rate of 10.4% in US dollar terms (1.3 times Sasol's weighted average cost of capital [WACC]).

Anyone who has ever built or renovated a house knows that large projects are unlikely to be completed timeously and on budget. This well-known fact, combined with the vagaries of oil and natural gas price fluctuations, meant that the LCCP was doomed to overrun. The 'robust' economics of the LCCP would soon be tested by external and internal conditions:

- The oil price crashed in late 2014, causing Sasol to reduce its long-term real oil price assumption to $80 per barrel. Under this scenario, the project's internal rate of return (IRR) would still be expected to exceed its WACC but fall short of the 10.4% project hurdle rate.

- In March 2016, Sasol announced a delay of six to 12 months, shifting the beneficial operation of the smaller derivative units out to 2019 due to the company pacing out the project in line with a lower oil price as well as 'some initial challenges'. These challenges resulted in Sasol revising the cost of the LCCP higher, to $11 billion in June 2016, due to:

  - construction delays caused by above-average rainfall and subsequent hurricanes (Harvey, Irma and Nate) off the Gulf coast;
  - poor ground conditions;
  - higher-than-expected labour costs;
  - certain components of the lump-sum bid contract prices being higher than originally estimated; and
  - required quantities of bulk materials overshooting the original estimates.

While these delays resulted in an approximate 25% increase in the cost of the LCCP to just over $11 billion, conditions deteriorated again in early 2019, as follows:

- IHS, the chemical consultancy used by Sasol on the project, reported a further potential delay of around three to five months. Sasol confirmed this delay in early February 2019, causing it to revise the LCCP cost higher, to between $11.6 billion and $11.8 billion.

- Despite reaffirming the revised cost at an investor conference in March 2019, Sasol then shocked investors in mid-May by revising the project's cost higher, to between $12.6 billion and $12.9 billion. This latest overrun resulted in Sasol lowering the overall expected IRR to between 6% and 6.5%, which is well below its WACC. This means that even if the remainder of the project unfolds as expected and in line with Sasol's financial assumptions, the LCCP would destroy significant economic value for shareholders.

The significant cost slippage and value destruction from the time of first approving the LCCP are apparent in the following table.

COST SLIPPAGE AND VALUE DESTRUCTION SINCE LCCP APPROVAL

Date	Cost ($ million)	% completion	Overrun	Expected IRR (in $ terms)	% of Sasol market capitalisation
Oct 2014	$8 900	LCCP approval	Initial cost	>10.4% (higher than internal project hurdle rate)	27%
Jun 2016	$11 000	50% completed	First overrun: higher contract and labour costs	>8%, but <10.4% (higher than WACC, but less than internal project hurdle rate)	53%
Nov 2017	$11 130	74% completed	Second overrun: hurricanes and lower productivity in ramp-up	>8%, but <8.5% (marginally above WACC)	55%
Feb 2019	$11 600 - $11 800	94% completed	Third overrun: additions to project scope and lower labour productivity	<7.5% (lower than WACC)	61%
May 2019	$12 600 - $12 900	96% completed	Fourth overrun: correction of duplicate investment allowances and increased cost to repair defective carbon steel forging	>6%, but <6.5% (lower than WACC)	82%

Sources: Sasol investor presentations, Coronation analysis

The net effect

The extent of cost overruns is truly breathtaking, and the impact on Sasol and its shareholders has been significant:

- Sasol had R10 billion in net cash just prior to greenlighting the LCCP. The significant cost of the project, coupled with overruns, has caused debt to balloon, with Sasol's debt-to-equity ratio now sitting at approximately 49% and likely to increase further.

  This indebtedness has reduced balance sheet flexibility, which means that Sasol has been unable to buy back its shares to take advantage of a depressed share price. It has also meant lower dividend payments to shareholders as it looks to shore up its balance sheet.

- Sasol announced a R30 billion to R50 billion cost-response plan that includes extracting cost savings, reducing dividend payments, delaying capital expenditure on its existing business, and seeking asset disposals for value.

  While it's always good practice to extract cost efficiencies, these initiatives raise concerns of plant underperformance if maintenance spend is curtailed, missed potential for value-accretive acquisitive opportunities, and the loss of key employees due to salary freezes and reduced bonuses.

Risks remain

While the value destruction suffered by shareholders is significant, the risks facing the LCCP have not abated. There is the potential for further overruns should the ramp-up transpire slower than envisaged. More importantly, the commodity cycle for the key chemicals that will be produced by the LCCP could change if global demand for these products slows. Given that these are niche products, any small changes in demand will have an outsized impact on the expected profitability of the LCCP, thereby further impacting on the project's ability to add value.

There is a well-known aphorism that states: "The road to hell is paved with good intentions". In a weak domestic economy, virtually every management team must feel the temptation to diversify offshore. However, these are not regions in which they have a competitive advantage and are almost certain to distract them from their local businesses.

Despite having the best intentions when looking to expand by acquiring businesses offshore, history, as demonstrated by the above examples, shows that reality can differ significantly from the attractive returns promised by a spreadsheet. What appears to be heaven can end up as hell for shareholders. With this in mind, as active investors, we continue to engage with the management teams and boards of directors of investee companies where we feel there is a risk of value being destroyed to ensure the best outcome for our clients over the long term. +

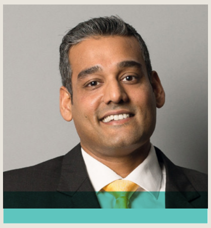
A time for good judgement

"Invest for the long haul. Don't get too greedy and don't get too scared." – Shelby M.C. Davis

By Nishan Maharaj

IN THE EARLY part of this millennium, the US accounted for about a third of global growth. Since then, the country's contribution has reduced to just under 25%, but arguably its influence on financial markets has increased. The US 10-year bond led the performance of global bonds in the quarter to end-June 2019 (Q2-19). Increasing concerns over lower growth due to the intensification of the US-China trade war, combined with benign inflation expectations, led to more dovishness from the US Federal Reserve (Fed) and the European Central Bank, which fuelled the global bond market rally. By the end of June, the US 10-year bond had rallied to 2% (down from 2.7% at the beginning of 2019), while approximately $13 trillion worth of global government bonds slipped into negative yielding territory. This spurred a rally in nearly all emerging market currencies and bonds, as the carry trade came back into vogue.

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



The All Bond Index (ALBI) was up 3.7% over Q2-19, bringing its return to 11.5% over the last 12 months. This performance is well ahead of cash (Q2-19: 1.7%; rolling 12 months: 6.9%) and inflation-linked bonds (ILBs) (Q2-19: 2.9%; rolling 12 months: 4.0%). The outperformance of the ALBI was driven by the seven- to 12-year area where bonds rallied 30 basis points (bps) to 50bps versus bonds with maturities longer than 12 years that only rallied 8bps to 10bps. Prospects of rate cuts in South Africa buoyed the seven- to 12-year area, while further fiscal deterioration due to lower growth and larger state-owned enterprise (SOE) bailouts weighed heavily on longer-dated South African government bonds (SAGBs). The strong performance of the ALBI over the last quarter, combined with the appreciation of the rand (2.3% versus the US dollar), put SAGB performance at 6.6% in US dollar terms, slightly ahead of global emerging market bond performance of 5.7% in US dollars (JP Morgan Government Bond Index – Emerging Markets Global Diversified Composite).

Top-down valuation of SAGBs is still quite attractive. Ten-year nominal yields of 8.8% with an implied real yield of 3.9% (one-year forward) is well above the emerging markets average nominal rate of 5.7% and average real rate of 1.7%. In addition, 10-year SAGBs yield 6.8% (8.8% minus 2%) more than the US 10-year. This is 1.2 standard deviations higher than the 10-year average, suggesting some degree of cheapness. However, as history has shown us, the bottom-up fundamental drivers of the local economy have been a much larger influencer of bond valuations over time. The two questions that need to be answered are around the sustainability of global bond yields (specifically US bond yields) and what magnitude of fiscal deterioration is being priced into local SAGBs.

In the US, over the next two years, the economy is expected to remain close to full employment, personal consumption expenditure (the Fed's preferred measure of inflation) is likely to remain sticky at around 2% and growth is expected to decelerate from 2.5% to 1.8%. In addition, average hourly earnings of employees (a large indirect contributor to US inflation) have been running well over 3% for almost 18 months and in excess of 2% for at least five years.

These are hardly the signs of an economy that is going into recession, or one that warrants a serious amount of monetary policy accommodation. The market is currently looking for approximately 1% worth of interest rate cuts over the next two years. The Fed's own projections suggest 0.5% worth of cuts over the next six to nine months and rates moving back up to current levels by the end of 2020. Given what is currently known about US inflation, growth and the US-China trade-war truce, the current pricing of the US 10-year bond seems expensive. Fair value for this instrument is probably closer to 2.75% to 3%, based on expected inflation of 2% and a real policy rate of 0.75% to 1% (a real policy rate more reflective of an economy growing at 2% per year and inflation at 2%).

On the local front, fortunately, inflation should average 5% until the end of 2021 due to the poor demand environment and subdued services prices. Unfortunately, growth is expected to average less than 1.5% over the same horizon, given the constraints on consumer spending and corporate investment. This benign growth and inflation environment should allow the South African Reserve Bank to reduce interest rates by around 0.5% over the next six to nine months, which is supportive for local bonds. However, given the slow nominal growth environment (a combination of slow real GDP growth and low inflation) and the need for more extensive support for SOEs (for example Eskom), government finances are set to deteriorate even further. Just using current economic assumptions, the budget deficit is likely to be well below -5.5% over the next three years and the debt-to-GDP ratio above 60% by 2021. Frontloading further support for Eskom will worsen these numbers. The budget deficit and the debt-to-GDP ratio will move to approximately -6% and 60%, respectively, a lot earlier (this does not include a debt transfer from Eskom's balance sheet to the sovereign's). The net effect would be a further deterioration in South Africa's creditworthiness, a downgrade to sub-investment grade by Moody's and an exit from the Citigroup World Government Bond Index (WGBI) by March 2020, if not sooner.

The fair value for 10-year SAGBs is approximately 8.62% to 8.82%. This is based on expectations of a US 10-year bond yield of 2.75% to 3%, South African expected inflation of 5%, US expected inflation of 2% and a South African credit spread of 2.87% (0.2% higher than the spot rate to factor in a further deterioration in South Africa towards subinvestment grade levels). At current levels of 8.68%, the South African 10-year bond sits in that fair value range (8.62% to 8.82%), but does not offer a large margin of safety. At best, it only warrants a neutral to slightly underweight allocation, given the impending fiscal risks.

LONGER-DATED SOUTH AFRICAN GOVERNMENT BONDS LOOKING ATTRACTIVE

In Q1-19, as evidenced by the performance of the various sectors of the ALBI, longer-end SAGBs (in the 20- to 30-year area) materially underperformed 10-year SAGBs. In the last year, the spread that the 20-year SAGB trades above the 10-year SAGB has moved from 0.5% to currently more than 1% above (see the first graph overleaf). On the surface, this looks like an attractive entry point. In the first table overleaf, we show a total return analysis for a few government bonds over three years in a scenario where bonds sell off or rally 100bps (1%). In addition, the last column shows the breakeven move for the longer-dated bonds relative to the 10-year bond (R2030) – that is, by how much those bonds can sell off before their total return equates to that of the 10-year bond. The results of our analysis are supportive of longer-dated SAGBs. In the event that bonds rally aggressively (100bps), longer-dated SAGBs outperform; if bonds sell off aggressively (100bps), one

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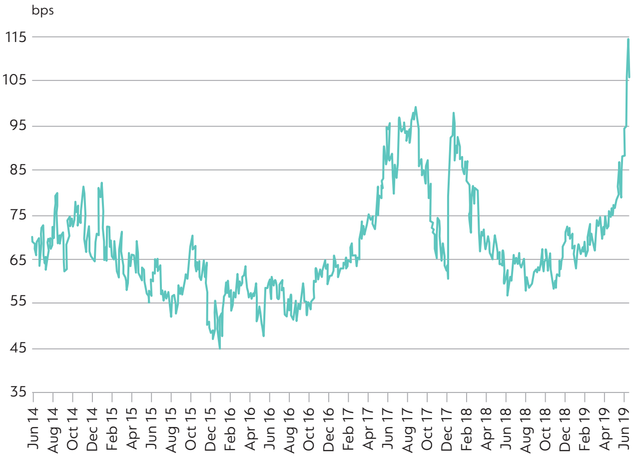
is no worse off than being invested in a 10-year SAGB. These bonds can sell off 30bps more (and so steepen 30bps relative to 10-year SAGBs) before their performance equates to the 10-year SAGB. Based on these results, the case for allocating capital to the long end of the SAGB curve is very compelling.

20-YEAR SOUTH AFRICAN GOVERNMENT BOND SPREAD OVER 10-YEAR GOVERNMENT BOND



Sources: Coronation, Bloomberg

TOTAL RETURN ANALYSIS: LONG-END BONDS

Bond	Maturity	Yield	Total return (1% rally)	Total return (1% sell-off)	Breakeven relative to 10-year SAGB
R186	21 Dec 26	8.09%	8.90%	7.00%	-
R2030	31 Jan 30	8.83%	10.00%	7.10%	-
R2035	28 Feb 35	9.44%	11.00%	7.20%	0.30%
R2040	31 Jan 40	9.65%	11.50%	7.10%	0.30%
R2044	31 Jan 44	9.70%	11.70%	7.00%	0.30%

Sources: Coronation, Bloomberg

SHORTER-DATED INFLATION-LINKED BONDS MORE FAVOURABLE THAN SHORTER-DATED NOMINAL BONDS

ILBs have underperformed nominal bonds for over 10 years now, with the underperformance being most pronounced in the last two years (ALBI 10.8%; Composite Inflation-Linked Index [CILI] 3.1%). This underperformance has been driven by a rally in nominal bonds and a sell-off in ILBs. Real yields have moved higher by approximately 150bps to 200bps over the last five years, depending on which area of the curve one is looking at. Most of the ILB yield curve trades close to, if not above, a real yield of 3%. This absolute level of real yield does seem attractive relative to history. In the table that follows, we run a total return analysis for nominal SAGBs and ILBs for parallel shifts in the yield curve (+50bps, +25bps and -25bps) and two inflation scenarios (average inflation over the next two years of 5% and 6.3%). For the ILBs, we show the relative total return to that of nominal bonds; for example, 0.7% implies, for that bond and scenario, that the ILB outperforms the nominal bond by 0.7%. As demonstrated in the table, the shorter-dated ILBs are more attractive than nominal bonds under all scenarios. Shorter-dated ILBs therefore warrant a more favourable allocation in a bond portfolio relative to shorter-dated nominal bonds.

INFLATION-LINKED BONDS: TOTAL RETURN ANALYSIS RELATIVE TO NOMINAL GOVERNMENT BONDS

Yield curve shifts	R197 (4-year)	I2029 (10-year)	I2050 (32-year)	R197 (4-year)	I2029 (10-year)	I2050 (32-year)
+50bps	**0.50%**	(1.30%)	(6.30%)	**1.50%**	(0.30%)	(5.00%)
+25bps	**0.70%**	(0.90%)	(3.70%)	**1.70%**	0.10%	(2.70%)
0bps	**0.90%**	(0.40%)	(1.00%)	**1.90%**	**0.60%**	0.00%
-25bps	**1.10%**	**0.10%**	**1.90%**	**2.10%**	**1.10%**	**2.90%**

Inflation scenario 1 (base case of 5% average inflation over next 2 years)

Inflation scenario 2 (stressed case of 6.3% average inflation over next 2 years)

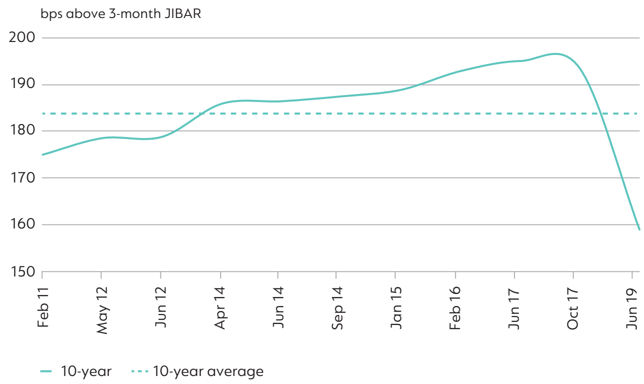
Sources: Coronation, Bloomberg

CAUTIOUS ON ADDING CREDIT AT CURRENT LEVELS

Corporate bonds (credit) have been a valuable tool within a bond portfolio when it comes to alpha generation. In the last two years, there has been a significant compression in corporate bond spreads that has made credit an outperformer among all asset classes.

However, one must not forget that holding credit assets in a portfolio is not riskless. Credit spreads do move, as is evidenced in the graph below, and being caught on the wrong side of the credit spread move can be very painful. In the last 10 years, the ALBI has increased in risk (modified duration), as issuance in longer-dated SAGBs (maturity >12 years) has increased, resulting in over 60% of the index now comprising longer-dated SAGBs. In the last decade, the modified duration of the ALBI has moved from approximately 5.5 years to 7.1 years, and the yield of the ALBI relative to a 10-year SAGB has moved from 0bps to 50bps over. This has meant that the hurdle for

STANDARD BANK SENIOR SPREADS



Sources: Coronation, Bloomberg

CREDIT INCLUSION AS PART OF BOND PORTFOLIO

Bank bond	Year of evaluation	Yield	Years to maturity	Spread to government (bps)	Spread to ALBI (bps)	Breakeven to ALBI (bps)
SBS9	2009	11.42%	7.0	250	222	41
FRX30	2019	9.64%	10.5	77.5	36	6

Sources: Coronation, Bloomberg

holding credit assets has moved higher. In the table above, we show fixed-rate credit spreads, relative to SAGBs, relative to the ALBI, and the breakeven-credit spread move relative to the ALBI (how much credit spreads can widen before that credit asset underperforms the ALBI). As is evident, the compression in credit spreads, combined with the increase in yield of the ALBI, has severely reduced the margin of safety when it comes to including credit as part of a bond portfolio, and we would be cautious on adding credit assets at current levels.

Cyclical economic factors are supportive of bond yields. Inflation should remain benign and growth subdued, which will allow an easing in policy rates. However, persistently low growth and the need for further support of SOEs will weigh heavily on government finances, resulting in wider budget deficits and a significant increase in the debt burden. SAGBs are most likely to exit the Citigroup WGBI in the next 12 months as pressure mounts on Moody's to move South Africa into subinvestment territory.

The global environment has turned more supportive for emerging markets and for South Africa, however SAGBs have a very limited margin of safety against a turn in global sentiment or a worsening in local economic conditions. Therefore, it is prudent to maintain a neutral to slightly underweight allocation to SAGBs at current levels. Any exposure to South African bonds should be taken in longer-dated SAGBs and shorter-dated ILBs. +

CORONATION INSIGHTS

2019 second quarter in review

CORONATION GLOBAL HOUSEVIEW STRATEGY

Equity markets continued to rise in the second quarter of 2019 (Q2-19) as central banks communicated a strong likelihood of rate cuts and US-China trade war tensions eased towards the end of the period. The MSCI All Country World Index rose 3.6% in US dollar terms in Q2-19, despite signs of slowing growth across many developed markets. Developed market equities rose 4.0% over the quarter, outperforming emerging markets, which grew by a more subdued 0.6%. The portfolio has benefited from its large exposure to global equities.

The Bloomberg Barclays Global Aggregate Bond Index appreciated by 3.3% in US dollars for the quarter. Global bond yields continued to rally in response to increasing evidence of a slowdown in global growth and rising expectations of interest rate cuts in the US and Europe. US 10-year bond yields have now traded down more than 100 basis points (bps) since November 2018, and the debt of several European sovereigns is trading at negative rates. Although global bonds have performed well, we remain of the view that yields are too low and the risk of capital loss to investors is considerable.

The All Bond Index (ALBI) ended the quarter strongly (+3.7%). The portfolio has a meaningful exposure to local bonds, taking advantage of the high real yields the asset class is offering. A low growth environment is impeding the ability of domestic businesses to grow earnings, increasing the relative attractiveness of bonds to equity. The weak local economy and contained inflation increase the likelihood of domestic interest rate cuts. This is further supported by anticipated US interest rate cuts. While a Moody's downgrade is likely, given muted economic growth and the precarious position of South Africa's large state-owned enterprises, bond yields appear sufficiently generous. Local bond yields already trade in line with subinvestment grade peers and at generous spreads relative to developed markets.

The outlook for local property remains constrained in a very weak economy with negative reversions and lower distribution growth. The portfolio retains selective domestic exposure via A shares (with their unique distribution structure) and high-quality property stocks. These assets should be better able to withstand challenging conditions. UK property stocks have disappointed, as Brexit and tenant failures undermine their prospects. We have retained a small exposure here given the significant discounts at which they trade relative to conservative valuations.

The JSE extended its first-quarter gains, albeit at a slower rate. The FTSE/JSE Capped Shareholder Weighted All Share Index appreciated by 2.9% during Q2-19. Resources were up 2.4% despite signs of slowing global growth, but lagged the stronger quarterly performances from the industrial (+4.0%) and financial (+5.4%) sectors. The outperformance of resources over one- and three-year periods remains considerable.

Domestic disputes

Despite the conclusion of the much-awaited South African election, domestic sentiment deteriorated during the quarter. The election result was broadly in line with expectations, with the ANC maintaining its majority rule with a slight decline in support. The appointment of a new, smaller cabinet was a positive development, reinforcing the message of fiscal discipline. However, the ruling party remains plagued by factional tensions, frustrating the ability of the President to deliver on much-needed reform. Policy uncertainty lingers, as reflected in divisive debate on land issues and South African Reserve Bank reform. Eskom's balance sheet problems remain an overhang. The government has signalled its commitment to support Eskom financially, though the underlying state of the utility's generation and transmission assets remains unclear. These factors combined to weigh on consumer and corporate confidence levels, and were reflected in a very weak first-quarter GDP print of -3.2% (released during Q2-19), dragged down by manufacturing and mining in particular. Results released during the quarter and the accompanying subdued rhetoric of management reinforce how challenging the underlying economic situation is. The weak domestic economy contained inflation, and favourable global rate expectations have increased the likelihood of future interest rate cuts.

In this environment, domestic stocks reported weak results, with even defensive stocks struggling to defy the pressures of several years of weak domestic economic conditions and high structural cost inflation. We expect these headwinds to persist and remain cautious on businesses heavily exposed to the local economy. Our exposure to domestic stocks is mostly through banks and defensive counters such as food retailers. The portfolio remains underweight domestically focused local stocks. We continue to debate whether these depressed conditions (and earnings bases) provide an opportunity to add meaningfully to domestic holdings, but have made no material changes to date.

British American Tobacco's share price declined during the period (-15.7%) as fears relating to low nicotine regulation in the US market resurfaced. British American Tobacco has faced a slew of potential regulatory headwinds in its US business, exacerbated by volume declines in traditional tobacco as new-generation products gain traction. We believe the underlying fundamentals of the business remain intact, with strong pricing power, improving cost controls and de-gearing continuing to drive earnings. In addition, we believe new-generation products are lower-risk products and present an opportunity to grow the overall market. British American Tobacco trades on 9.1 times one-year forward earnings and a 7.3% dividend yield. We believe this to be very attractive for a stock of this quality and it remains a large position in the portfolio.

The resources sector (+2.4%) showed mixed performances, with Sasol's underperformance (-22.2%) offset by a strong performance from gold miners (+29.6%) and platinum (+9.5%). Iron ore (+32.9%) has been particularly strong, as supply disruptions have driven up near-term prices, supporting the portfolio's large holding in Anglo American. This position was trimmed during the quarter. The Sasol share price declined meaningfully when the company announced that its Lake Charles Chemicals Project (LCCP) would a) cost more to deliver and b) produce a lower normalised level of profitability. Disappointments in the delivery of the LCCP have meant a further reduction in the already muted returns offered by the initial projections, which carried significant risk (a fact Coronation highlighted to the board in a letter sent in 2013). The portfolio has been underweight Sasol, but has added to the position on the back of the price weakness. As the project nears completion, execution risk should reduce, and the group earnings base is anticipated to increase by between 20% and 30%. However, given the heightened risks (operational and financial), we have limited Sasol's overall position size within the portfolio.

We remain meaningfully invested in platinum counters. We reduced our Anglo American Platinum position in response to its strong share price rise, reinvesting the proceeds into names that have underperformed on a relative basis. The demand outlook for platinum group metals (PGM) remains strong, buoyed by increasingly stringent emissions regulations. While we expect electric vehicles to play a role in future mobility solutions, we see a structural deficit in PGM markets over the next decade as supply remains tight after years of under-investment. Despite the upwards move in the price of these metals, PGM producers are not yet earning fair returns on their invested capital. We believe prices need to rise further to incentivise sufficient ounces.

The financial sector (+5.4%) performed strongly for the quarter, as local banks (+9.7%) have defied domestic market headwinds and are expected to deliver underlying earnings growth. This growth reflects prudent management through the cycle, with limited credit extension resulting in low credit loss ratios. The portfolio has holdings in several of the large banks, including FirstRand, Nedbank and Standard Bank.

Brexit disarray

Political turmoil continued to reign in the UK with the resignation of Prime Minister Theresa May during the quarter. The Labour Party's indecisiveness on several key issues reduced the strength of the opposition's position. High levels of uncertainty in the UK undermine the economic outlook. Despite this, compelling valuation-driven opportunities exist. Quilter remains the portfolio's largest single holding in the UK. This is a business with a structural growth opportunity stemming from pension reform in the UK market. The portfolio has built up its position in Bidcorp, a food services company that continues to benefit from consumers' desire for eating out of home and operates across many markets. While we see exciting investment opportunity in the UK market, the portfolio continues to tightly manage overall UK exposure, given the uncertainty.

Markets have remained challenging this year, with several companies reporting material earnings disappointments that have put these businesses at risk. A rigorous research process and heightened balance sheet scrutiny have protected the portfolio from several of these examples. We remain committed to building robust, diversified portfolios with a focus on risk management. We believe these efforts will protect the portfolio against unexpected outcomes and position the portfolio well to deliver inflation-beating returns over the long run.

GLOBAL EMERGING MARKETS

The Coronation Global Emerging Markets Strategy had a good quarter, returning +5.2% compared to the MSCI Emerging Markets Index's return of +0.6%, and in doing so outperformed the market by 4.6%. Year to date the Strategy has generated a return of +29.8%, leaving it 19.2% ahead of the market's return of +10.6%. We note that this is an extremely short time period and, in our view, performance is better assessed over very long time periods. In this regard, since inception 11 years ago, the Strategy has outperformed the market by 4.3% per annum and by 3.0% per annum over both the last 10- and seven-year periods.

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During the quarter to end-June 2019, the five largest positive contributors were Wuliangye Yibin (+23.0% return, +0.8% contribution), Adidas (+28.5%, +0.7% contribution), Sberbank (+22.7%, +0.5% contribution), X5 Retail (+42.7%, +0.5% contribution) and LVMH Moët Hennessy Louis Vuitton (LVMH) (+17.2%, +0.4% contribution). There were only two negative detractors of note (greater than 0.5%): YES Bank (-0.9% contribution) and British American Tobacco (-0.6% contribution).

We sold totally out of the YES Bank position during the quarter due to a combination of factors, the top being concerns over additional bad debts after the March year-end results were published. This worsened the bank's capital situation and accelerated the need for a capital raise, which would be very dilutive to existing shareholders after the share price decline. The last straw was the forced appointment of a director to the Board by the Reserve Bank of India, which we interpreted in a negative light. In stark contrast to this, we continue to hold the view that British American Tobacco, on less than 10 times earnings and a 7% dividend yield, is very attractive and at the time of writing was a 3.8% position in the Strategy, making it a top 10 holding.

Eastern exposure

There were four new small buys (c. 0.5% positions each) during the quarter: 51job (China), Tata Consultancy Services (TCS) (India), Hero MotoCorp (India) and Bank Central Asia (BCA) (Indonesia), together totalling 2.0% of the Strategy. In terms of sells, in addition to YES Bank we also sold out of Indiabulls Housing Finance due to concerns over the sustainability of its wholesale funding model going forward.

In terms of other activity, we added to the Alibaba and AIA positions on share price declines and reduced the Brazilian education exposure (Kroton and Estácio). We continue to like both Kroton and Estácio (1.7% positions each at end-June, so 3.4% total Brazil education exposure), with both trading on 10 to 12 times earnings, but elevated competitive intensity in the industry, together with increasing student loan books and an ongoing weak economic environment, led us to conclude that smaller positions were more appropriate from a risk-adjusted expected return point of view. Both shares have done well this year, with Kroton having appreciated by 40% year to date in US dollars and Estácio by 35% at the time of writing. We also reduced the Cognizant position on concerns over excessive cost cutting, with the bulk of this going into TCS.

In terms of country exposure, the largest upward change was an increase in China from 29.0% at end-March to 32.6% at end-June, largely as a result of the new 51job purchase and the additional Alibaba buying. In contrast, exposure to India declined from 12.6% at end-March to 9.6% at end-June due to the sales of YES Bank and Indiabulls, and our Brazilian exposure reduced from 9.6% to 8.5% due to the trimming of the Brazilian education stocks.

All four new buys were small positions, which simply reflect the risk-adjusted expected return of each of these – in summary, all four are reasonably attractive, as opposed to very attractive. We have, however, continued to add to two of the positions post quarter-end as their respective share prices declined, and at the right price will also add to the other two positions.

Outsourcing is the business

The first new buy was 51job, which the Strategy has owned in the past. 51job is China's leading online recruitment operator in the white-collar space. This provides two thirds of its revenue, with the balance coming from human resource (HR) services such as business process outsourcing (BPO) when clients outsource HR functions such as payroll management to the company. 51job was founded 21 years ago and management owns 25% of the business. In the 15 years since the company listed on the Nasdaq, profits have grown by 21% per annum. In our view, there is still a large opportunity in both areas of this business: 51job has 500 000 corporate users of its online recruitment services and 10 000 corporate users of its BPO services – out of a market size of 85 million registered businesses in China and growing. In addition to this, the company is very free cash flow generative (having converted 128% of accounting net profit into free cash flow over the past 10 years) and has a rock-solid balance sheet, with net cash of over $1 billion (or 25% of its market capitalisation). 51job today trades on c. 20 times forward earnings (15 times ex the net cash position), which in our view is attractive for a company of this quality and with this market opportunity.

TCS was the second new buy (0.65% position) and is also one that the Strategy has owned before. TCS is arguably the gold standard of the Indian IT services and outsourcing companies. These firms (TCS, Infosys, Wipro, HCL, Cognizant, etc.) all generate 80%+ of their revenue from the US and Europe, but all have c. 60% to 70% of their employee base in India, a source of abundant engineering skills.

In our view, TCS is a high-quality business, with returns on equity of 35%, stable earnings growth, earnings before interest and taxes margins consistently in the mid-20s, and a high level of conversion of accounting earnings into free cash (90%+). We have held four meetings with the company over the past several months and these interactions were a clear reminder of these intrinsic qualities. At the same time, we became somewhat less enthusiastic about Cognizant due to clear signs that cost cutting (arguably driven by an activist investor) had gone too far. As a result, we reduced the Cognizant position (from c. 2% of the Strategy to 1%) and bought an initial position in TCS.

The third new buy was a 0.5% position in BCA, the leading privately owned bank in Indonesia, in a market where the big competitors are mainly State owned. The Indonesian financial services market is one of the lowest penetrated markets in emerging markets, and BCA is clearly the highest quality bank in the country. Over the past 10 years, BCA has grown loans by 17% per annum, earnings per share by 16% per annum and net asset value by 21% per annum. The bank is conservatively managed and has significant excess capital, with a Common Equity Tier 1 ratio of 23%. It has the highest current and savings account ratio (c. 78%) in the market, which in turn gives it a lower cost of funding versus competitors. It also has among the highest provision ratios (c. 180%) and the best bad debt experience historically out of the major banks. Again here, a number of meetings over the past year or so led us to want to own this asset. Neither TCS nor BCA look particularly cheap on short-term valuation metrics (c. low 20s forward price earnings) but both are very high-quality assets in our view, which should be able to compound earnings in the double digits for several years ahead.

Road hog

The last new purchase was that of Hero MotoCorp (0.4% position). The company is lower down the quality spectrum than TCS or BCA, for example, but has a number of qualities that we like, and after a 35% decline since its peak price in mid-2017, it trades on c. 15 times forward earnings, with a 4% dividend yield and a strong balance sheet (net cash position). Hero is the largest manufacturer of two-wheeler (motorbike) vehicles in India, a market which has historically grown at a high rate and is still underpenetrated, but which is going through a tough period currently after industry volumes were hit by the tightening of requirements to purchase third-party insurance along with the bike purchase.

Hero is the clear market leader in the entry-level market (75cc to 110cc, where they have c. 50% market share) and in the 'executive' market (110cc to 125cc, where they have close to 70% market share). Overall, of the 20 million motorbikes sold in India annually, 7.5 million are sold by Hero. Besides being dominant in the entry-level market, Hero has recently put more effort into making inroads into the scooter and premium markets, and the export market also holds large potential. It is unclear yet as to the level of success the company will have in these areas, and we will continue to evaluate this over time, but in our view, the entry-level and executive markets alone will provide many years of growth.

Members of the Global Emerging Markets team continue to travel extensively to enhance our understanding of the businesses we own in the Strategy, their competitors and the countries in which they operate, as well as to find potential new ideas. In the second quarter, there were trips to India, Thailand, Hong Kong and Singapore. The coming months will see trips to China and Russia. The Strategy's weighted-average upside to fair value at the end of June was c. 35%, which we feel is compelling. We would also consider the overall quality of the stocks held in the Strategy currently to be above average compared to other points in the Strategy's history.

FRONTIER MARKETS

Global Frontier Markets

The past three months have been tough for the Strategy. It delivered a gross return of -5.7% over Q2-19, while the MSCI Frontier Markets Index was up 4.7%. Since inception, the Strategy return is 2.3% per annum, which compares to 0.8% per annum for the Index.

Argentina was up 27.1% over Q2-19 as the market rallied strongly in June following a very weak start to the year. Romania (+12.0%), Croatia (+6.6%) and Morocco (+4.4%) also did well. Pakistan (-23.6%), Kenya (-6.6%), Vietnam (-3.6%) and Nigeria (-3.2%) all declined.

The Strategy's relative performance is a function of three main drivers: a write-down to our Zimbabwean holdings; large-cap Kuwaiti stocks benefiting from an upcoming index upgrade, and share price moves in some of our large holdings that do not appear justified by fundamentals (or phrased differently, the normal short-term volatility in the market).

Zimbabwe formally introduced a local currency in February 2019 and announced the end of the multicurrency regime in June 2019. At this point, the Zimbabwean dollar became the only form of legal tender in the country. During the quarter, the stock market rose by 66% in Zimbabwean dollars, but this was not nearly enough to offset the currency move. The official exchange rate moved from ZW$3/US$1 to a rate of almost ZW$7/US$1 at the end of June, although there is limited information on liquidity at this rate. Please refer to the Africa Frontier Markets notes overleaf for more detailed commentary on Zimbabwe.

Upward mobility

During the quarter, two significant events impacted the MSCI Frontier Markets Index. Argentina, the largest constituent of this Index, was upgraded to the Emerging Markets Index in May. MSCI also announced that Kuwait (the largest constituent following Argentina's departure) would likely be upgraded to the Emerging Markets Index subject to some minor market access changes. The Kuwait Premium Index, which comprises those stocks likely to be included in the upgraded Index, is up 9.0% over the period. We have seen this before in the United Arab Emirates, Qatar and Pakistan, where markets perform very strongly on the rumour of inclusion. We estimate that the move in these Kuwaiti stocks resulted in a -2% attribution during Q2-19.

We have commented before that as benchmark-agnostic investors we do not buy or sell companies based on whether they are included in an index. These announcements have no impact on the underlying fundamentals of businesses. They are an example of the inefficiencies that exist in financial markets, as index trackers become forced sellers or buyers based on these changes. Frontier markets in particular are susceptible to this and present opportunities for bottom-up valuation-driven investors willing to take a long-term view. In the short term, this can and does result in periods of large divergence between the Index and the Strategy's performance.

BYMA (Argentine stock exchange, +52bps), TGS (Argentine gas distributor, 40bps) and Centamin (Egyptian gold miner, +35bps) where the largest contributors over the quarter, while Delta Corporation (Zimbabwean brewer, -196bps), Eastern Tobacco (Egyptian tobacco, -80bps) and Kohinoor Textiles (Pakistani investment company with cement and textile assets, -73bps) were the largest detractors.

The Strategy's largest buys over Q2-19 were Nigerian Breweries and Dragon Capital's Vietnam Enterprise Investments Limited (VEIL) fund. Over the past few years, Nigerian Breweries has faced numerous challenges, which we discuss in more detail in the Africa Frontier Markets note below. Dragon Capital's VEIL fund invests in Vietnam. It holds many companies that we view as attractive investment opportunities but for which foreign ownership limits prohibit direct purchase at quoted prices. Buying VEIL allows us to access these opportunities without paying the large premiums required to attract foreign sellers.

Grameenphone and Global Mediacom were the largest sells during Q2-19. We sold out of Grameenphone, as the margin of safety no longer sufficiently justified a position in the Strategy following the announcement of a huge tax claim by the government of Bangladesh. While Grameenphone is contesting this claim, the share price at the time of our sale did not adequately reflect the risks involved. Global Mediacom was switched into one of its subsidiary companies, Media Nusantara. This was due to relative valuation and sees the Strategy hold a higher quality, pure-play asset in the Indonesian media space.

We are mindful that this has been a particularly tough quarter for the Strategy, but we continue to be excited by its holdings. Many of the positions trade at multiyear low valuations, despite underlying fundamentals remaining healthy. For the patient investor, returns should be compelling.

AFRICA FRONTIER MARKETS

After a very strong start to the year, the performance of markets across Africa was mixed over the last three months to end-June 2019 (Q2-19). The FTSE/JSE All Africa ex-South Africa 30 Index (JA30) ended the quarter with a return of +1.5%, largely driven by a 4.4% gain in Morocco. Kenya (-6.6%), Nigeria (-3.2%) and Egypt (-0.7%) all declined during Q2-19.

While the moves in these markets were significant, they were nothing compared to the volatility we saw in Zimbabwe following the formal introduction of a local currency in February 2019. This was followed by an announcement that ended the multicurrency regime last month, and the Zimbabwean dollar is now the only form of legal tender in the country. During the quarter, the stock market rose 66% in Zimbabwean dollars, but this was not nearly enough to offset the currency move. The official exchange rate moved from ZW$3/US$1 to a rate of almost ZW$7/US$1 at the end of June. There is limited information on liquidity at the official rate, and as foreign investors, this is still not a window through which we can freely access US dollars.

We have seen a similar move in the rate implied by the Old Mutual dual-pricing mechanism, where the 'exchange rate' moved from about ZW$5/US$1 in March to a rate of over ZW$9/US$1 at the end of June. It has been clear for a while now that a dollar in Zimbabwe is not equal to a US dollar. For this reason, we changed our valuation approach for Zimbabwean assets in 2017 and decided to value these assets at our internal fair values. These fair values were well below the quoted share prices and were also below the values implied by the Old Mutual discount.

However, the volatility during Q2-19 meant that the share prices, adjusted for the Old Mutual rate, moved below our internal fair values. Given all the developments over the past few months, we had to re-evaluate the valuations for in-country Zimbabwean assets. We decided to value each security at the price implied by the Old Mutual 'exchange rate', and on top of this we apply a discount to reflect the market movement cost to liquidate the position. To reduce the volatility, we use one-month averages rather than spot prices. This valuation approach reflects an appropriate realisable value for the full Zimbabwe exposure. In our view, this approach is symmetrical for investors purchasing and redeeming, and does not disadvantage a long-term investor in the Strategy.

In from the cold

This change resulted in a large write-down of our assets in Zimbabwe. This write-down alone reduced the value of the Strategy by approximately 13% and was the main reason why the Strategy declined by 13.9% over Q2-19. Despite this significant write-down, we are satisfied with the Strategy's long-term performance. Over a three-year period, it delivered a return of 6.4% per annum, compared to the Index return of 7.0% per annum. Since inception more than a decade ago, the Strategy returned 7.7% per annum, compared to the Index which returned -1.1% per annum over the same period.

While the liquidity situation continues to deteriorate, we have seen some positive news out of Zimbabwe. In June, the IMF agreed to a Staff-Monitored Programme, with commitments from the Zimbabwean government to address the wage bill, subsidies and the printing of money. If successful, this could lead to financial assistance and re-engagement with the international community. In addition, the government's willingness to allow the official exchange rate to move closer to the parallel market rate over the last few weeks, is also something we view as encouraging.

Quality is quality

We did an exercise in mid-June where we compared the three-year total return (in US dollars) of Safaricom in Kenya to that of Econet in Zimbabwe. The results are quite surprising, as shown in the table below.

Safaricom is a highly rated business. It performed very well, both operationally and in terms of share price performance. On the other hand, Econet has been operating in a very tough environment and the currency devalued meaningfully (it was at parity to the US dollar three years ago). However, the table below shows that Econet performed better than Safaricom over this period, when using the official exchange rate as well as when using the Old Mutual implied rate to convert the share price into US dollars. For investors who followed their rights in the 2017 rights issue, the return would have been even higher.

THREE-YEAR TOTAL RETURN IN US DOLLARS

Safaricom			
Absolute return over 3 years	73%		
Annualised return	**20%**		
Econet			
Exchange rate used	**Offical interbank rate**	**Old Mutual implied rate**	**Rate we used to value Econet in the Fund**
Absolute return over 3 years	200%	88%	(25%)
Annualised return	**44%**	**23%**	**(9%)**

Sources: Coronation, Bloomberg

We believe that the Zimbabwean assets in the Strategy offer significant value. Companies such as Delta Corporation and Econet Wireless are well-run businesses, with market-leading positions. They have operated during tough times before and emerged as stronger businesses. Despite the macroenvironment, these businesses continue to perform well. For example, Econet's mobile money business has close to 100% market share in a country where virtually all payments now happen electronically, and it has seen a dramatic increase in profitability.

Another example is Zimplats, a low-cost platinum mine in Zimbabwe. Zimplats generates real US dollar revenues, which puts this business in a very strong position in a country with a shortage of hard currency. In fact, Zimplats has been the largest contributor to performance so far during 2019, benefiting from the rise in PGM prices over the past year.

Too early for beer?

We increased our exposure to Nigerian Breweries, which has faced numerous challenges over the past few years: downtrading due to the economic environment, a period of limited access to foreign exchange, an excise hike in 2018 and aggressive competition in the market, which intensified when Anheuser-Busch InBev (which is lossmaking in Nigeria) opened a new brewery last year. All this means that brewers have not been able to increase prices; in fact, in real terms, the price of beer in Nigeria has declined drastically over the past five years and is now much lower than in many other countries in Africa. As a result, the profitability of Nigerian Breweries declined considerably and its market capitalisation fell 84% in US dollars over the past five years, down from over $8 billion to only $1.3 billion currently.

We cannot say when conditions will improve, but the tough macroeconomic environment will not last forever and at some point, the competitive pressures will ease. Long term, we believe that both Heineken and Anheuser-Busch InBev are rational operators who want to generate an appropriate return on their investments. For this to happen, beer prices will have to increase.

While we risk being early, we believe that the attractive valuations as a result of the current headwinds present a fantastic opportunity for investors who are willing to look through the near-term challenges, as the Nigerian beer market remains incredibly attractive long term, with a large, fast-growing population and beer consumption still low relative to other markets.

To conclude

The Strategy's performance over Q2-19 has been disappointing, but we believe the write-down of the Zimbabwean exposure was prudent and protects our investors. We have a long-term, valuation-driven investment philosophy and we do not base our investment decisions on a company's size in an index. As a result, we know there will be periods of underperformance while we wait for the investment thesis to play out in each of the companies we own. If we look at the current valuations of the companies we own, we are extremely excited about the Strategy's return prospects over the long term. ✚