AUGUST 2018

PROSPERITY

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INTRODUCTION

Markets remained difficult to navigate during August as deteriorating trade tensions, emerging market turmoil and tightening monetary policy in the US kept investors on edge. Yet, the US powered ahead, with both the S&P 500 and Nasdaq Composite indices setting new records at the end of the month. Earnings of US companies are strong as predicted by the 40% cut in federal corporate taxes effective at the start of 2018. Leading indicators remain benign with regard to the outlook for US equities over the next 12 months. However, investors should guard against complacency. The impact of draining liquidity is being felt as interest rates tighten. Emerging markets are bearing the brunt of pain as their currencies decline and sovereign debt yields rise. Turkey, Venezuela, Argentina, South Africa and others may have different political-economic idiosyncrasies, but the reduction in global liquidity is exposing all these economies in a similar manner: fiscal deficits are being punished. While China may be more resilient in the final analysis, there are risks too. Japan is still going about its business of rejuvenating economic activity and is appearing even more attractive than Europe. The UK continues to bear the consequences of Brexit-induced uncertainty. While there are still enough investment opportunities, we are entering the later stage of the business, credit and monetary cycles where the risks are rising. Investors will do well by being extremely selective and identifying businesses that will be resilient to the inevitable shocks. Considering one's total wealth, an appropriate level of diversification across asset classes is advisable.

Apple made financial history at the start of August by becoming the first US$1 trillion company. It comes 31 years after IBM became the world's first US$100bn company, which itself came 32 years after General Motors reached a US$10bn valuation. At this rate, we might expect the first US$10 trillion firm to materialise sometime around 2050. A long-term perspective indeed does reward the patient investor.

"I believe social responsibility begins with a strong, competitive company. Only a healthy enterprise can improve and enrich the lives of people and their communities." – Jack Welsch

ECONOMIC OVERVIEW

Turmoil in emerging markets took centre stage in August. Turkey's financial woes escalated into a full-blown crisis, with other emerging markets including South Africa suffering some collateral damage. Turkey faces challenges on a number of fronts. It is in an unstable neighbourhood. It runs a large current account deficit, meaning it is highly reliant on foreign capital inflows. Fiscal stimulus has fuelled rapid growth, but also inflation, which has been worsened by currency weakness. However, President Tayyip Erdogan has strong-armed the central bank into not responding with sufficient interest rate increases. Turkey also has one of the largest dollar and euro-denominated debt loads among emerging markets, and as the lira falls, the debt burden grows. Turkish 10-year bond yields spiked above 20%. Such stiflingly high borrowing costs could do serious damage to the economy and the banking sector in particular. Promises by the finance minister – Erdogan's son-in-law – of a more sustainable and balanced growth model were ignored by the markets. Put simply, investors have lost faith in Turkey's governing institutions and things could get worse before they get better.

Argentina's problems also escalated. The peso slumped to a new record low of 37 to the US dollar. This occurred despite the central bank hiking short-term rates to 60%. The Argentinean government requested that the International Monetary Fund (IMF) accelerates payments of the record US$50 billion bail-out. But rather than comfort markets, it had the opposite effect.

Other emerging market currencies sold off in sympathy. The rand lost 11% during the month of August. This was in line with the Brazilian real and the Russian rouble, but worse than the Indian rupee's 4% decline (though the rupee fell to a record low against the greenback). The lira, in contrast, slumped 37% and the peso by a similar amount during the month. While there has been a spill-over from Turkey and Argentina to other emerging markets, it is still not full-blown contagion. Markets are seemingly still drawing a distinction between countries that are in deep trouble and those that are merely vulnerable.

All this has been happening against the backdrop of three emerging market-unfriendly global developments in recent months: US interest rate hikes and a stronger dollar, trade disputes and a cooling of China's economic growth rate. Unlike previous episodes of emerging market stress, there is very little chance that the US Federal Reserve will pause on its path of gradually hiking rates. After all, the US economy is strong, and inflation is creeping up.

MARKET OVERVIEW

The JSE All Share Index ended the month at 58 665 points after reaching the 60 000 level on Tuesday 28 August 2018, a level last seen six months ago. MTN took the biggest knock in August after the Nigerian government accused it of illegally moving funds (dividends) out of the country between 2007 and 2015. MTN has been asked to return the funds, totalling US$8.1 billion. Global markets welcomed the news of the USA and Mexico reaching a trade deal, easing tension between the two countries. While Canada is yet to agree to the terms of the deal, President Trump insists the door remains open for them to negotiate. As mentioned, emerging markets came under the spotlight as emerging market currencies fell. The rand wasn't spared, falling to a low of R15.47 to the US dollar. Looking at the month ahead, the US Fed is likely to hike interest rates in the coming months, which could place further pressure on emerging market currencies. In the USA, the S&P 500 and Nasdaq reached record highs and the Dow Jones reached 26 000 on the back of US second quarter GDP increasing 4.2%. Businesses in the US increased their spending on software thanks to the Trump tax cuts and imports declined. Brent crude rose from US$72 to US$77 per barrel and, combined with a weaker rand and rising inflation numbers, paints an unwelcoming picture for local economic consumer dynamics.

GLOBAL EQUITIES

WALT DISNEY Q3 2018

Although Walt Disney missed analyst expectations on revenue growth and earnings in its 3Q18 results, performance was strong, with revenues up 7% to US$15 billion driven by 20% growth in Studio Entertainment. Total operating income was up 5% y-o-y for the quarter off strong Parks, Resorts and Studio Entertainment contributions that were offset by increased cost pressure. The result was a 1% decline in operating margin for the quarter. Excluding the impact of the US Income Tax legislation on current earnings, diluted earnings per share were up 29% to US$1.95 for the quarter, supported by a 30% decrease in provision for income tax. Cash generation remains strong year to date with a 19% increase in cash generated by operations. However, there was a 25% decrease in free cash flow during the quarter to US$2.4 billion due to higher film and television production spending.

Parks and Resorts revenues rose 6% to US$5.1 billion for the quarter and 11% for the year to date. This translated into 15% growth in operating income to US$1.3 billion indicating strong margins as average domestic ticket prices increased ahead of inflationary pressure on costs. Shanghai and Hong Kong Disneyland Resorts posted higher operating income due to attendance growth which offset lower guest spending. **Media Networks** revenue increased 5% for the quarter to US$6.2 billion driven by 11% growth in the Broadcasting division. **Studio Entertainment** was most notable, posting a 20% growth in revenue to US$2.9 billion and 11% growth in operating income to US$708 million following the good box office performances of Avengers: Infinity War and Incredibles 2 as well as continued contributions from Black Panther. Ant Man and the Wasp, released in July, and Wreck-it Ralph 2 as well as Mary Poppins Returns are among the notable 4Q 2018 releases expected to drive performance for the next quarter. The Disney-branded **streaming service** remains on track for a late 2019 launch which will include a live-action Star Wars series and new episodes of the Star Wars: Clone Wars with more details promised to be released at an investor presentation.

As the structural shift within the media industry continues and consumers change their viewing habits, we expect there to be clear winners and losers. Our view is that the long-term beneficiaries of this change will be the content providers, rather than the distributors. Disney has an enviable collection of brands and rights, which we believe best position the business to navigate the ongoing changes. Disney's segments leverage off each other in a way that its peers cannot match. Brands within the Group's studio division benefit the theme park and consumer product segments, which in our view forms a high barrier to entry and protects the Group's margins. While ESPN continues to face headwinds due to a decline in subscribers (cord-cutting and skinny bundles), we believe that the sports rights that the Group has secured and the acquisition of Bamtech will allow the Group to successfully transition ESPN into a highly profitable direct-to-consumer streaming service.

MEDTRONIC

Medtronic reported 1Q19 results that beat expectations on both the revenue and earnings lines, aided by good organic growth across all divisions. While group revenue for the quarter decreased 0.1% on a comparable constant currency (CCC) basis, revenue increased 6.8% to $7.4bn relative to expectations of 4.6% CCC growth. Gross margins expanded 200bps over the quarter to 70.2%. Operating profit grew 7% to US$1.9bn with margin expansion of 5bps. Adjusted EPS for the quarter came in at US$1.17, representing growth of 9% y-o-y. The company showed astute cash management over the quarter with $1.7bn cash flow from operations and $1.4bn free cash flow generation. The company projects FY19 organic revenue growth of 4.5-5% (up from 4-4.5% at the previous quarter), operating margin expansion of +50bps which should see EPS grow between 9-10%.

The **Cardiac and Vascular** Group (38.1% of revenue) reported 5% y-o-y growth. Coronary and Structural Heart showed continued strong growth, +11% y-o-y driven by market share gains in Western and Eastern Europe for their market leading products in the heart valve industry and launch momentum of the Resolute Onynx stent. The **Restorative Therapies** Group (26.4% of revenue) grew at 7% y-o-y, reflecting the best quarter in the division's eight-year history. Emerging Markets growth stood out, climbing 15% y-o-y. The **Diabetes** Group (7.7% of revenues) showed confirmation of the late FY2018 recovery with 26% y-o-y growth in revenues.

Medtronic is the world's largest medical device manufacturer with a historic focus on chronic care and fast growing into holistic patient treatment. As societies grow, become richer/move up the income scale and age, the demand for healthcare increases. With a geographic footprint that spans 150 countries and a treatment range that covers Cardiac, Minimally Invasive Therapies, Spinal and Brain ailments/procedures and Diabetes care, we believe Medtronic is suitably positioned with the right level of scale and scope to grow with the major demographic trends driving global healthcare demand. Medtronic is a leader in leveraging growth opportunities offered by the healthcare industry's shift to value-based reimbursements. This speaks to healthcare providers moving to a fee-for-service structure which places substantial emphasis on the ability to monitor and report clinic quality and cost data. In the long-run, this speaks to a shared-value model where healthcare providers are remunerated based on the success/meeting of targets of the specific healthcare provided. Additionally, as a medical technology leader, Medtronic has built a strong competitive position with regards to medical data capture. The Group's institutional knowledge and experience with clinical data makes them a preferred partner for healthcare payers and providers. This is a growing theme, not only in the medical space. Medtronic's scale and broad client base also affords them attractive cash generation characteristics. Balance sheet strength is strong with a declining debt profile and high cash balance which provides flexibility for acquisitions, research and development and marketing support for product launches.

LOCAL EQUITIES

QUILTER PLC

Quilter Plc produced maiden listed results that were well-received by the market. Not only did the business return to meaningful profit growth, but net client cash flows (NCCF) (excl. Quilter Life Assurance) was a solid £3.0bn with integrated flows up by 17%, representing the bulk of NCCF over the period. Notably, this was achieved against the backdrop of flat market returns. Group revenues grew 11% y-o-y to £385mn, led by good growth in net management fees. Disciplined cost management across both Advice and Wealth Management and Wealth Platforms led to Group operating margin expansion of 200bps to 29%. Together with an income tax credit and the once-off profits from the sale of the Single Strategy business, basic earnings per share grew 264% to 18.7 pence per share. Adjusted for once-offs, basic diluted EPS grew 25% to 5.5 pence per share. The Group also announced a special interim dividend of 12.0 pence per share. South African shareholders are entitled to a gross dividend of 206.42 cents per share.

Advice & Wealth Management grew revenue by 22.3% to £181mn. Higher average Assets under Management (up 16% to £43.7bn), led by both Quilter Investors (multi-asset asset manager) and Quilter Cheviot resulted in higher net management fee revenue for the period. **Wealth Platforms** grew revenue by 2.5% to £203mn as a result of higher net management fees from increased Assets under Management and Administration (AuMA). AuMA for the Group was £116.5bn, up 2% from end December 2017. The Group achieved a cash generation rate of 83% of adjusted profit, in line with the end-December 2017 figure. The Group ended the first half with a Solvency II surplus of £1.11bn representing a Solvency II Ratio of 195% or almost 2x the required level.

Quilter's core offering is advice-led, using financial advisers to target affluent customers with investable assets between GBP100k to GBP5m. The Group is well-diversified amongst its peers, deriving revenue and earnings from a vertically integrated advice value chain. This allows Quilter Plc to control product, distribution and ongoing client management which is a key differentiator and advantage relative to peers. The UK pension market is currently undergoing a phase of consolidation brought upon by both structural and regulatory changes, which present Quilter Plc with a supportive environment for business growth. We believe this will allow Quilter Plc to gain and maintain clients and meaningfully grow profits in an attractive wealth and savings market.

MONDI

Mondi reported strong half-year 2018 results with earnings before interest and tax (EBIT) beating consensus estimates by 9%. The industry theme for 2018 has been for good demand across packaging products as well as higher average selling prices. Both of these factors represented the largest EBITDA contributors on a year-on-year basis. Group volumes were flat over the period confirming the weakness in the Consumer Packaging segment and the structural shift in the Uncoated Fine Paper segment. Revenue was up 4% on a like-for-like basis due to higher selling prices across all businesses. Operating profit grew 4.3% y-o-y to €530mn after once-offs largely related to asset impairments and restructuring across the Packaging Paper and Consumer Packaging segments. While higher commodity and energy costs coupled with inflationary cost pressures affected profitability, the bulk of inflationary-related costs were passed onto customers. The Group declared an interim dividend of €21.45 per share, in line with a targeted dividend cover range of between 2-3x underlying earnings.

Packaging Paper grew earnings by 55% y-o-y due to significantly higher selling prices, volume growth and a better mix, which more than offset cost and currency pressures. While this segment experienced some rationalisation, it remains the most profitable by a decent margin. **Consumer Packaging** reported revenue and operating profit that was marginally down on the previous half year. The Group has been active at restructuring this segment's cost base, readying the business for a more supportive volume environment. The segment recorded a charge owing to a plant closure in the UK. Additionally, the Group is priming the segment to lead the market in producing hybrid, flexible packaging that uses 70% less plastic than more rigid alternatives. Innovation that will become more material as regulations tighten on non-recyclable waste producers and providers.

Mondi, primarily through acquisitions, continues to make progress transitioning to Consumer Packaging-focused business lines. The defensive nature of Consumer Discretionary and Staples spend adds a great diversification element to Mondi's product mix and positions them for the rise of middle-income consumers in developing regions.

The Group drives organic growth through innovation and cost control. Their continued focus on customer value-add and forging long-term relationships with stakeholders helps to entrench their market-leading positions across various product types. This has seen them maintain significantly higher margins relative to peers over the past five years. Mondi's growth prospects are supported by the recovery in Europe, increased global consumer and business sentiment and diverse operational and revenue bases. Mondi maintains healthy cash generation, manageable debt levels and an investment pipeline totalling over €800mn, signalling a strong position from which to finance future growth.

WOOLWORTHS GROUP

WOOLWORTHS

Woolworths Holdings posted full year 2018 results in line with the trading update provided earlier this year. Performance was severely impacted by the David Jones R6.9 billion impairment posted during 1H18. Turnover is up 1.6% to R75.2 billion supported by the Food division, which comprised 43% of group sales, followed by David Jones at 21% and the South African clothes division, now the laggard, at 20% of total sales. Profit before tax is down more than 100% to a loss of R3.5 billion from the R5.4 billion profit last year. Adjusting for the David Jones impairment, adjusted profit before tax is down 13.8% to R4.8 billion. Headline earnings per share declined by 17.7% to 346.3 cps and this in turn impacted the dividend, down 23.6% to 239 cps. As a result of the poor performance, return on equity declined to 18% from 20.8% in the prior period. Free cash flow before dividends, including strategic capital expenditure, is down 62% to R2.1 billion. Adjusting for strategic capex and business acquisitions and disposals, free cash flow before dividends is down 3% to R2.7 billion. Management forecasts capital expenditure of R3.3 billion in FY 2019 driven by strategic initiatives.

Fashion, Beauty and Home sales declined by 1.5% to R13.6 billion with comparable store sales down 4.1%. Online sales grew 77.3% y-o-y due to increased availability and online promotions. This supports the Group's strategy to reduce additions of trading floor space over the next three years. Management have indicated that this segment will receive increased oversight and be subject to improved discipline in the design review process. **The Food** division continues to be the Group's star performer, posting sales growth of 8.4% to R30 billion, with comparable store sales up 4.8%. Gross profit margins were maintained at 25% supported by better waste and rebates. Tough economic conditions and transformational initiatives were cited for a poor **David Jones** result, though an improvement on the prior period. Total sales were down 0.9% to R22 billion for the year. Major transformational initiatives have been completed at David Jones and management will now focus on cost control with the aim of developing a more cost efficient Australian structure. The **Country Road** Group grew sales by 1.7% to R10.6 billion driven by strong performance in key brands such as Witchery and Mimco. Management maintained their medium term FY2021 operating profit margin targets for each segment indicating their belief in the success of their turnaround initiatives.

While over the short-term we expect the Clothing and General Merchandise division to remain under pressure hampered by cyclical and structural headwinds, over the medium-term we expect a gradual recovery in consumer confidence coupled with interest rate cuts to support this division's recovery. While margins in this segment have declined, we believe they are close to the trough and a recovery in volumes will support earnings recovery. Within the Group's SA food division, we believe that current efforts by management to make Woolworths Food more competitive while focussing on a wider product range will, in time, result in greater market share. Despite increased competition from peers, we expect customers' perceptions of Woolworths' quality and the Group's price investment in key categories will continue to draw customers. The Group has made some progress in bedding down the David Jones acquisition. There are green shoots indicating that the introduction of food into David Jones is resulting in increased foot traffic, a trend that we expect to continue going forward. We believe that the space rationalising within David Jones, introduction of private label brands and cost cutting will stand Woolworths in good stead when the Australian economy picks up.

OLD MUTUAL

OLDMUTUAL

Old Mutual delivered good maiden results, showing strong growth in Net Client Cash Flow (NCCF), profitability and earnings and importantly meeting target performance metrics. Other highlights include an improvement in historically underperforming Old Mutual Insure, and growth in Funds under Management to R1.1 trillion. NCCF was up R7.8bn y-o-y, totalling R9.4bn. The Group reported Results from Operations (RFO) of R4.84bn, up 7% from HY2017 and Adjusted Earnings of R5.39bn or 112.3 cents per share. Additionally, the Group declared a first interim dividend of 45 cents per share together with a special dividend of 100 cents per share. Together with the 801 cents per share in the Nedbank distribution/unbundling, around R9.50 per share will be distributed to shareholders during the final quarter of 2018, representing almost a third of Old Mutual's market capitalisation.

Old Mutual now reports on the following six segments: Mass and Foundation Cluster (31.7% of RFO), Personal Finance (18.6% of RFO), Old Mutual Corporate (17.6% of RFO), Wealth and Investments (15.7% of RFO), Old Mutual Insure (6.7% of RFO) and Rest of Africa (9.7% of RFO). Nedbank results are included as "income from associates". The **Mass and Foundation** Cluster delivered excellent top-line growth with similarly strong profit growth. Life Annualised Premium Equivalent (APE) sales grew 21% y-o-y on increased advisers and higher productivity. Loans and advances grew 11% y-o-y due to process enhancements around customer take-ons. RFO (Old Mutual's preferred measure of profitability) grew a strong 17% to R1.53bn while Value of New Business (VNB) increased 12% to R655mn. **Personal Finance**, despite being a meaningful distribution channel for other segments, disappointed with Life APE sales down 2% y-o-y to R1.22bn and RFO down 34% to R918mn. Personal Finance experienced poor recurring premium sales of savings and risk products whilst single premium sales grew on improved guaranteed annuity rates. Segment RFO was down on poor results from death and disability claims and lower investment returns earned. **Old Mutual Corporate** showed double-digit top-line growth together with good profit growth. Life APE sales were up 25% on HY 2017 to R1.45bn with strong single premium policies being the greatest driver. Divisional NCCF showed a reversal of last year's decline, growing R1.1bn to R0.8bn on much improved sales growth and lower client losses. RFO was up 7% to R854mn on management actions to improve the underwriting experience and benefit design of the group income protection product. **Wealth and Investments** showed good flows and strong profit growth. Gross flows were up 6% to R45.11bn while NCCF grew R9.1bn from HY 2017. Old Mutual's **Rest of Africa** operations benefitted from the political developments in Zimbabwe as well as the continued turnaround of the East African business. Despite decreases in GWP (-7% to R1.78bn) and NCCF to R700mn, the segment experienced 26% growth in loans and advances (driven by CABS in Zimbabwe) and RFO growth of 30% to R478mn on improved Zimbabwean, Namibian and Malawian performance. **Old Mutual Insure** was the stand-out performer in terms of y-o-y improvement. Gross Written Premiums ("GWP") grew 3% to R6.29bn while RFO was up 85% to R370mn. Tough market conditions and tighter underwriting conditions hampered new business volumes however the segment's younger iWyze brand showed strong growth. The segmental highlight was the growth in underwriting result and margin, growing 181% and 410bps to R270mn and 6.4% respectively. The combination of a benign claims environment, and improved cost and process control has allowed the underwriting margin to move above the top-end of the target range.

Old Mutual is now two thirds complete with the managed separation process first announced in early 2017. Since then the Group has sold non-core businesses, listed and disbursed Quilter Plc to shareholders and completed the listing of Old Mutual on the Johannesburg Stock Exchange. All of these steps have unlocked value along the way. In fact, Old Mutual's share price is up 11% relative to the All Share Index over the past year. The final act will be the distribution of 32% of Nedbank to Old Mutual shareholders, targeted for Q4 2018. In line with our previous investment thesis, we believe that there is still a value unlock for shareholders with the expected distribution of Nedbank being the final catalyst.

CONTACT US

CAPE TOWN

Century City

TEL: 021 524 4581
ADDRESS: Old Mutual Wealth, The Estuaries, 2 Oxbow Crescent, Century City, 7441
EMAIL: PCS@omwealth.co.za

Stellenbosch

TEL: 021 861 5300
ADDRESS: The Vineyard, Building B, Corner Adam Tas and Devon Valley Road, Stellenbosch, 7600
EMAIL: PCS@omwealth.co.za

JOHANNESBURG

TEL: 011 245 3610
ADDRESS: 1 Mutual Place, 107 Rivonia Road, Sandton, Johannesburg, 2196
EMAIL: PCS@omwealth.co.za

PRETORIA

TEL: 012 369 7220
ADDRESS: 43 Ingersol Road, 3rd Floor, Podium at Menlyn, Lynnwood Glen, 0081
EMAIL: PCS@omwealth.co.za

KWAZULU NATAL

Umhlanga

TEL: 031 581 0699
ADDRESS: 61 Richefond Circle, 2nd Floor Ridgeview Building, Ridgeside Office Park, Umhlanga Ridge, KwaZulu-Natal
EMAIL: PCS@omwealth.co.za

Kloof

TEL: 031 767 7300
ADDRESS: 75 Old Main Road, Unit 7, Kloof, KwaZulu-Natal
EMAIL: PCS@omwealth.co.za

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