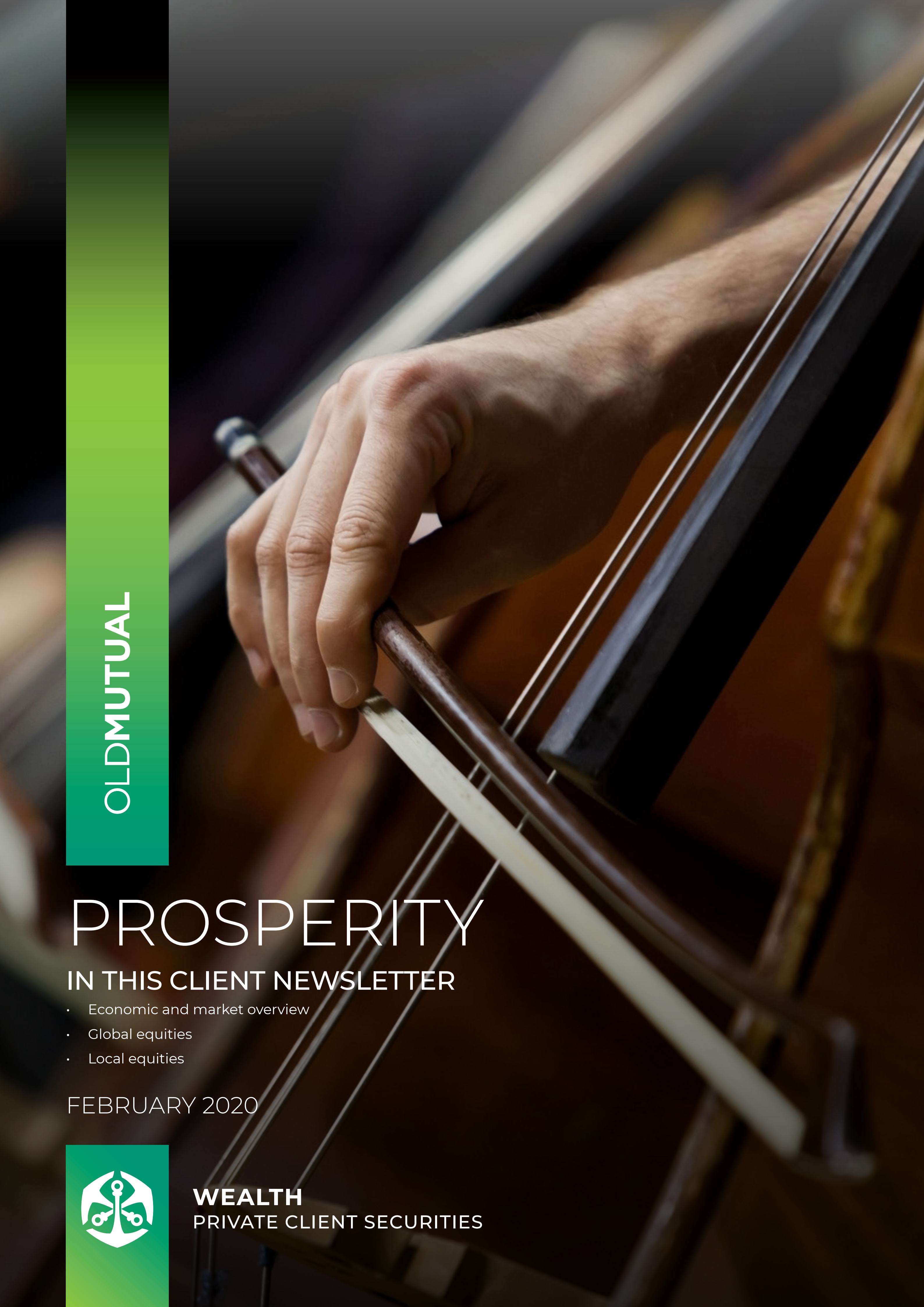

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PROSPERITY

IN THIS CLIENT NEWSLETTER

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FEBRUARY 2020

WEALTH
PRIVATE CLIENT SECURITIES

29 February 2020 presented us with one extra day to adjust our calendar to the true duration of earth's orbit around the sun – a quarter of a day longer than the 365 we normally count in a year. Unfortunately, this leap year will be remembered for all the wrong reasons. The human tragedy inflicted by the novel coronavirus outbreak is undeniable, but it is also extremely important to retain perspective in such times. For investors with a long-term horizon, current events will be seen in the context of the "wall of worry" that markets continue to climb. It could even be seen as the necessary adjustment to moderate unrealistic growth expectations. While we cannot predict the true extent of the virus' ultimate impact on the global economy and markets, we cannot expect it to blow over without impact. However, growth will ultimately resume and markets will adjust for this.

Given that markets worldwide have experienced significant selloffs, it is important to remember that volatility and drawdowns are inherent in equity investing. Very often, markets experience intra-year declines well in excess of -10% yet, they still manage to deliver a positive return for the calendar year. By exiting the market during periods of heightened volatility, investors run the risk of missing out on the upswings that inevitably materialise and offset the short-lived losses. The best course of action is to stay invested. History shows that since the late 1800s, there has never been a period of negative real returns for investors who have remained invested for a 20-year period. These periods include both World Wars, the Great Depression and the Global Financial Crisis - events that arguably would have had larger impacts on the markets than the current coronavirus outbreak. This highlights the power of remaining invested for the long term.

"Success in investing doesn't correlate with IQ ... what you need is the temperament to control the urges that get other people into trouble in investing. Market turbulence will happen. It's not an 'if,' but a 'when'. So, be ready for them. Mentally prepare yourself to not panic during downward moves, and to bargain-hunt for shares of your favourite companies on sale." – Warren Buffett

ECONOMIC UPDATE

This year's Budget Speech occurred against the backdrop of a deep and sustained global equity sell off as investors reacted to the rapid spread of the coronavirus outside China. While generally well received, the market impact of the Budget was overshadowed by global developments, highlighting that global considerations outweigh local factors when it comes to investments.

Most South Africans tune into the Budget simply to find out the impact on their taxes. Some taxes, like the fuel levies and 'sin' taxes on tobacco and alcohol always rise since they are not percentage based and have to be adjusted for inflation. This year, the news for taxpayers was quite good. Faced with a massive tax revenue shortfall (due to a weak economy) and rising spending pressures (SOE bail-outs), government opted not to implement major tax rate increases. In fact, there is some relief (R2 billion) for bracket creep, the tendency of higher inflation to push taxpayers into higher tax brackets. Put simply, the weak economy cannot stomach higher taxes at the moment. In fact, we recently learned that the economy is in a technical recession, with negative economic growth in the third and fourth quarters of 2019 (-0.8% and -1.4%) respectively. While the news of the technical recession would not have been a surprise to anyone, the extent of the decline was unexpected - and excludes any potential negative impact from the coronavirus.

Given the weak economy, government chose to cut projected non-interest, non-bailout spending. In particular, the big announcement was a R160 billion reduction in the wage bill over the next three years. As opposed to civil servant salary cuts, growth in salaries and benefits will slow relative to what was projected in last year's Budget. The wage bill will still grow, but below inflation over the next three years, if things go according to plan. Crucially though, this will depend on negotiations with public sector unions that have already expressed hostility at the idea.

The willingness to tackle the wage bill, which had become unsustainably large, is the main reason for commentators and investors welcoming the Budget. However, these measures really only scratch at the surface since the budget deficit will still average more than 6% of GDP per year over the medium term. The cumulative debt-to-GDP ratio is set to rise above 70%. While this is not high by global standards, the International Monetary Fund has flagged it as uncomfortably high for an emerging market since it means that there is almost no buffer to a future shock (such as the current global pandemic). The debt ratio continues to rise rapidly, making interest payments the fastest growing item in government expenditure. With no major new announcements on stimulating economic growth, the Budget arithmetic remains extremely challenging.

The biggest internal obstacle to economic growth is simply excessive government intervention in the economy, which, while mostly well meaning, is ineffective at best and harmful at worst. Eskom is case in point: a monopoly electricity provider that cannot provide enough electricity despite the tripling of tariffs and the surge in borrowing. There are many other mini-Eskoms scattered throughout South Africa. Minister Mboweni has been beating the drum on this topic for a while, but he has yet to convince his colleagues in Cabinet. If there is a sustained global slowdown because of the coronavirus, it will weigh on South African growth too and ultimately place additional pressure on government's finances.

What are the ratings implications? Ratings agencies provide an opinion on the creditworthiness of a borrower. They each have a scale running from AAA to D which indicates how likely a borrower is to service and ultimately repay its loans. In a weak economy, with tax revenues under pressure and spending demands high, the government's ability to service its debt has eroded. Hence, Fitch and S&P have assigned a sub-investment grade (junk) rating and Moody's is likely to follow suit. However, there is no real danger of the SA government defaulting on its debt, as Argentina seems set to do (for the seventh time in the past 100 years). Most borrowing is in rands, and there is a large savings pool available to fund the government if the yields on offer are attractive. So perhaps the key question is whether the valuations of SA bonds, equities and the rand reflect the risks. By and large, they do.

MARKET UPDATE

February was a brutal month for global equity markets as the spread of the coronavirus sent investors fleeing from risky assets. Over a period of six days, the coronavirus-driven market selloff wiped more than US$6 trillion in value from global equity markets. Most indices entered correction territory after falling more than 10% from their most recent highs. The Dow Jones, S&P 500 and the Nasdaq ended February down 10.1%, 8.4% and 5.9% respectively. In China, production came to a standstill as people were urged to stay indoors to prevent the virus from spreading, following the closure of factories as big centres went into lockdown. The Purchasing Managers Index (PMI) in China came in at a record low of 40.3 for the month of February, with the Shanghai Composite closing the month down 3.2%. Europe also saw losses, with the Stoxx600 index down 8.5% and the DAX falling 8.4%. In the UK, the FTSE dropped 9.7%.

At the end of February, the JSE All Share Index closed at 51,038, its lowest monthly close since November 2018 with financials down over 8%, industrials lower by 6.5% and resources losing 11.6%. Commodities did not escape the pain, with the gold index closing lower after reaching an 18-year high through the month. Brent crude lost more than 12%, due to a big decrease in demand and stalled negotiations between Russia and OPEC, and closed the month at US$50.52/barrel, the lowest close since June 2017.

GLOBAL EQUITIES

L'Oréal

World leader in beauty, L'Oréal, closed out the decade with its fastest growth in 12 years, generating sales of €29.9bn (+8%) in 2019, well ahead of the beauty market (+5%). While all divisions posted strong growth, Asia Pacific was the stand out, growing sales by 25.5% (on a comparable basis) and claiming the top spot as the largest L'Oréal market. Sales on digital platforms accelerated 52.4% and now account for 15.6% of total group sales. L'Oréal continued to invest in its digital presence, allocating half of its media budget to digital channels with the intention of capturing the millennial market. L'Oréal's portfolio of luxury brands grew to nine, with the addition of skin care brand, La Roche-Posay. The group continued to generate superior shareholder returns, with share price appreciation of 31% during the course of 2019, ahead of the 25% generated by the MSCI World Index. The board maintained the group's 55% dividend payout policy, declaring a dividend of €4.25 per share (+10%).

Founded in 1909, L'Oréal has become the world's top selling cosmetics group, housing 36 brands within 150 countries. The beauty market is forecast to continue growing at mid-single digits over the medium term driven by growth in luxury products and active cosmetics. L'Oréal has consistently outperformed the market in terms of earnings and volume growth, being the only company active across all beauty categories. The company trades at a premium valuation, which we believe is justified by its quality of earnings, strong balance sheet and superior ESG metrics.

S&P Global

S&P Global reported solid annual results, posting revenue growth and impressive margin improvement. Revenue was ahead of expectations (+7% to US$6.7bn), driven by growth in all four reporting segments. Effective management of expenses and strong revenue growth drove a 1.4% improvement in the operating profit margin to 50.9% and contributed toward a 9% increase in net income to US$2.3bn. Adjusted diluted earnings per share (EPS) came in strong at US$9.53, representing a 12% increase and was ahead of analyst expectations. During the year, the company made a number of key investments and product innovations to ensure future growth. Most notably, S&P Global launched a ratings agency and Market Intelligence franchise in China, expanded their ESG activities and applied automation and artificial intelligence.

S&P Global's business model allows it to earn recurring revenues, maintain high margins and generate high levels of free cash flow in an oligopolistic industry. The group is well diversified, with meaningful contributions from varied segments that operate within financial services. We expect each of the segments to continue to benefit from structural trends within financial services such as disintermediation, passive investing and high debt levels.

Alphabet

Alphabet reported 2019 annual results that, while light on revenue, surpassed earnings per share expectations. While group revenue disappointed, growth in Google's core advertising segment was up a strong 15.8%, as search and YouTube ads delivered over the period. Alphabet was subject to a US$1.7bn anti-trust fine, which affected earnings during the first quarter. Despite the fine, full year earnings grew 12.5% to US49.16c per share, supported by growth in YouTube ads and Google Cloud, and declining cost growth.

Some highlights from the results include the 15th anniversary of Google Maps, which with the help of machine learning, has digitised as many buildings in 2019 as were added over the previous decade. Google's neural-network based technique for natural language processing now covers over 70 languages and influences 10% of all searches. Benefitting from this increasingly diverse user base, Google Assistant now helps more than 500 million users a month across 90 countries and multiple devices, from smart speakers and displays to phones, TVs and cars.

Nestlé

Nestlé, the world's largest food and beverage company, reported a decent set of full year results. Revenue (CHF92.6bn) increased by 1.2% year-on-year, just shy of analyst expectations of CHF93.4 bn. Organic growth was strong at 3.5% (2.9% volume and 0.6% pricing), driven by strong momentum in the US and Purina PetCare globally. Operating profit grew 4.8% to CHF16.3bn, with operating profit margin reaching 17.6%. Margin expansion was supported by structural cost reductions, pricing and improved sales mix. Earnings per share was strong, up 11.1% to CHF4.30, comfortably beating consensus estimates by 2%. During the year, the company completed acquisitions and divestments of around CHF10.4bn, with the most significant transaction being the divestment of Nestlé Skin Health for CHF10.2bn. In December, management reached an agreement to sell Nestlé's US ice cream business for US$4bn to the Froneri ice cream joint venture with PAI Partners. Management regretfully noted that 2019 was light on acquisitions and heavy on disposals, but stated that 2020 should be better, with more projects in the pipeline.

Management continue to align the product portfolio with consumers' shifting preference for health products. This is likely to position certain parts of the business well for the long term. Management have taken a stern stance to underperforming product categories with a "fix it or exit" approach. This will ensure the company remains invested only in product categories that are earnings accretive.

Berkshire Hathaway

Berkshire Hathaway, the American multinational conglomerate operating more than 90 businesses, grew revenue 2.7% to US$211bn during 2019. The group's operating businesses reported earnings of US$29.2bn (+0.32%) as gains from the rail and energy business offset losses from the reinsurance operation. An equity market recovery generated a gain on the group's US$248bn portfolio of US$71bn driving overall net earnings higher to US$81.8bn from US$4.3bn in the previous year. Warren Buffett assured investors that there would not be a flood of Berkshire shares on the market following his death as his will stipulates that his Berkshire "A" shares must be converted into "B" shares and distributed to various foundations over a period of 12 – 15 years. He further advised that the group is well prepared to continue business as usual after his death. As the group's cash continues to increase (US$125bn) with no mammoth acquisition target in sight, Berkshire repurchased 1% of the outstanding shares of the company for US$5bn during 2019.

Berkshire has a reputation of increasing its commercial value, and the group's competitive advantages across their insurance and non-insurance businesses will continue to drive long-term, sustainable growth, regardless of any acquisitions completed in the future. The group's substantial cash reserves should further support growth by enabling bolt-on and large acquisitions as well as continued investment in its equity investment portfolio.

LOCAL EQUITIES

BHP Group

Over a period of moderating global economic activity and growth, the world's second largest miner, BHP Group, delivered healthy first half results supported by improved iron ore pricing and copper production. Revenue and underlying EBITDA (earnings before interest, tax, depreciation and amortisation) grew 7% and 15% to US$22.2bn and US$12bn, respectively. Unit costs were broadly lower across the portfolio, reflecting higher volumes, improved capacity utilisation and lower maintenance at selected mines. Production guidance remains unchanged; however, petroleum volumes are expected at the lower end of the range due to the impact of Tropical Cyclone Damien in early February 2020. While the first half results exclude any impact from the coronavirus, BHP noted that should the outbreak not be well contained by end March, they expect to revise their commodity growth expectations downwards.

BHP's portfolio, although still dominated by iron ore, shows an increasing focus on petroleum and copper, with these commodities seeing the largest capex contributions over the recent past. This portfolio has a strong consumer and emerging markets tilt, with all four major commodities linked to growing middle-income consumers. This is a long-term theme that we believe BHP is well placed to benefit from.

Woolworths

Local fashion and food retailer, Woolworths disappointed investors and analysts with a poor interim result in which headline earnings declined 10.1% to R1.80 per share. Weak retail sales growth in SA and Australia caused increased discounting and competitiveness among retailers, placing pressure on operating margins. Woolworths Fashion, Beauty and Home (FBH) and The Country Road Group (CRG) lost market share over the period due to an inappropriate fashion and pricing strategy. This resulted in Woolworths FBH and CRG reporting profit declines of 8.9% and 9.7% respectively. The Food division continued to post strong results in a benign growth environment, with profit growth of 8.0%. Trade in the first six weeks of the second half of 2020 saw continued pressure in Woolworths FBH (+0.4%) and a welcome recovery in David Jones (+2.4%) and CRG (+4.2%). However, management cautioned for a negative impact on sales in Australia and on product availability across both markets as a result of the coronavirus. In line with the new dividend policy, a dividend of 89 cents per share was declared, down 3.3% on the prior interim period.

After nine years at the helm, Ian Moir has stepped down as the group's CEO, though retaining his position as acting David Jones CEO. The group CEO position has been filled by SA-born Roy Bagattini who was previously president of the Americas market for Levi Strauss & Company. He played an instrumental role in the development and acceleration of the e-commerce and omni-channel capabilities of Levi Strauss and now has a mammoth task ahead in restoring investor and consumer confidence in the once admired SA retailer.

Anglo American

Benefitting from diversity across their portfolio, Anglo American delivered growth in revenue and earnings that surpassed market estimates. While diamond and coal performance disappointed, higher prices for iron ore and Platinum Group Metals (PGMs) drove revenue and EBITDA growth. Group Revenue and EBITDA grew 8.2% and 9.2% to US$29.8bn and US$10bn, respectively. Unit costs were 6% lower, the lowest since 2010, and reflective of beneficial currency movements and strong production from Minas Rio (iron ore). FY 2020 production guidance points to slightly higher volumes across diamonds and similar output for other commodities with the exception of Kumba Iron Ore and metallurgical coal, which have been moderated lower. While management provided no definitive comments on the potential impact from the ongoing spread of the coronavirus, they did highlight uncertainty with regards to diamond sales and the iron ore market. The latter they believe will impact peers more so than Anglo. However, with China (29.7%), Japan (9.8%) and Other Asia (19%) combining to 58.5% of group revenue, we remain cautious and anticipate some downside to short-term guidance.

Anglo's mix of commodities will benefit the company going forward as stimulus measures in China will increasingly favour consumption driven sectors and de-emphasise large scale investment activities (such as property and infrastructure). With a move to a more electrified world, there will be a lot more demand for copper and with production scheduled for 2022 at Anglo American's Quellaveco mine, they will disproportionately benefit from this theme.

Shoprite

Africa's largest retailer, Shoprite, delivered mixed interim results in the context of weak local and volatile African trading environments. Group revenue was up 7% to R81.2bn, driven by strong local supermarket growth. Trading profit declined 3.9% to R4.0bn; however, normalised trading profit (excluding hyperinflationary adjustments) grew 7% to R4.1bn, driven again by local supermarkets reflecting improving local dynamics. Hyperinflationary adjustments adversely affected headline earnings, which declined 2.6% to R3.72 per share. Excluding the hyperinflationary adjustment, diluted HEPS grew 15.7% to R3.79 per share. Following their massive IT platform investment, Shoprite has made progress in utilising increased customer data to drive engagement: the Checkers Xtra Savings Rewards Programme was launched in October 2019 and now has 3.8 million customers. Additionally, the group launched a one-hour grocery delivery service, Sixty60, in November 2019 across eight stores. Although it is still early, these initiatives improve the business' customer value proposition, which should lead to increased brand equity and customer loyalty over the long term.

Leveraging its scale, Shoprite generates some of the most attractive margins in the sector. This also serves to boost its cash generation ability, supporting balance sheet management and shareholder payments. Following a period of high capital expenditure, management are now focused on business optimisation, market share gains and balance sheet "right-sizing", which should improve free cash flow and unlock shareholder returns over the medium term. After years of low-cost supremacy catering to lower LSM groups, Shoprite has effectively gained market share among relatively more affluent consumers. The group's continued penetration of this segment serves as an attractive growth area that will drive both sales volumes and economies of scale, as well as enhance margins over time.

Mondi

Mondi Plc, a global leader in packaging and paper solutions, produced full year results that, while meeting expectations, are reflective of the challenging and uncertain trading and economic environments. Hampered by both lower prices and sales volumes, revenue declined 2.9% to €7.2bn while operating profit, boosted by lower operating expenses, grew 2.4% to €1.2bn. Underlying earnings per share (excluding special items) declined 9.5% to 171.1 euro cents per share. Basic earnings per share was down 1.5% to 167.6 euro cents per share.

On coronavirus, management highlighted there has been no impact on the group to date. Mondi's direct exposure to China is limited, with revenues from the country accounting for less than 1% of the total. On Brexit, management have been monitoring trade inflows between the UK and EU to better understand the possible consequences. Mondi operates two flexible packaging plants in the UK, which supply containerboard and uncoated fine paper within the region. However, these will be closed through the course of this year. Given that customers in the UK account for around 3% of total sales, management do not expect Brexit to materially impact normal business operations.

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