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PROSPERITY

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OLD MUTUAL WEALTH

At the 2017 half-way mark it is useful to remember that when we invest in companies it is more important to consider the future than the past. Financial results reflect past activity. While it is important to understand these results, it is even more vital to understand how these were produced and what the company's activities and positioning mean for the future. If you know what management is doing and understand the dynamics of competition and the cycles of the sector, it is possible to remain a satisfied investor even if the financial results disappoint. A Prime example – pun intended – is Amazon. This month the headlines have been awash with news of Amazon's acquisition of Whole Foods Market and now also Nike's partnership with the company. Clearly it is becoming a juggernaut in the retail space. However, Amazon's past financial results have discouraged many investors. This company for many years invested heavily in its infrastructure – from warehouses to data centres – and many investors could not tolerate the poor financial results (large quarterly losses). Those who remained invested understood that the spending was essential for the company to achieve the scale it required to disrupt the retail sector. Only three and a half years ago in December 2013, due to its poor financial results, Amazon's share price was knocked from its then record high of US$400 to under US$300 for most of the following year (2014). Now the company is reaping the benefits of its investments and the financial results show it. Furthermore, the market's appreciation of its strategy and execution is showing in its share price. Since the end of 2014 the share has not only recovered, it is now trading at over 300% higher. We have seen a similar story playing out in Naspers and its investment in Tencent and other online ventures – heavy investment is required to build the scale needed to dominate a market.

"In the short term, the market is a popularity contest. In the long term, the market is a weighing machine." – Warren Buffett

ECONOMIC AND MARKET OVERVIEW

Monetary policy is firmly back in the spotlight. The US Federal Reserve (the Fed) hiked rates for the fourth time in the current cycle, taking the fed funds target range to 1% - 1.25%. The projections for future rate hikes remained unchanged, showing that the fed funds rate is expected to eventually settle at 3%. However, while unemployment has declined substantially, wage growth has not accelerated and inflation remains subdued. In fact, the last few months have seen a run of weakening inflation numbers, calling into question whether the Fed will persist with its planned hikes. If it does, it might be making a costly error. While US households have been reducing debt for the past 10 years, debt levels remain high and potentially vulnerable to higher rates. In the meantime, though, consumer confidence is high and spending fairly robust.

European Central Bank president Mario Draghi caused a stir when he noted in a speech that "reflation" was replacing deflation thanks to a much stronger Eurozone economy. Markets seized on these comments, viewing them as a signal that reduced bond buying lay ahead (echoing 2013's "taper tantrum" when then Fed Chair Ben Bernanke suggested quantitative easing could be pared back). Bonds sold off and the euro rallied against the dollar. While the Eurozone economy is certainly doing quite well at the moment – with a broad range of confidence measures at multi-year highs – there is also very little actual inflation. And as in the US, the most recent inflation prints have been declining, not rising.

The South African economy declined in real terms at an annualised rate of 0.7% quarter-on-quarter in the first quarter of 2016. This means the local economy is in a technical recession. The GDP numbers emphasise that the weakness of the domestic economy should not be understated, and certainly there is an urgent need for policy makers to step up with the right measures and reforms to get the economy going again. An end to political and policy uncertainty will help tremendously. At the same time, investors should guard against overstating domestic economic weakness. Compared to the first quarter of 2016, the economy grew by 1% in real terms, the fastest growth rate in seven quarters.

Global stock markets, with the exception of a few, retreated off their recent highs as muted economic data and geopolitical tensions weighed on indices in June. US markets ended the month mixed, as financials rallied on the back of their recent positive stress test results, while technology stocks felt the pain of investors' selling. In addition, the US dollar declined further and the dollar index dropped below 96 for the first time this year, which brings us back to pre-election levels for the greenback. Commodity prices declined in the month, with gold, platinum and oil all drifting lower as investors chased riskier assets, predominantly in Japan and China, which performed better, especially with Chinese manufacturing rebounding to the best level in three months.

Having touched levels as low at R12.62/US$, the rand lost ground through the second half of the month to close around R13.05/US$. Ongoing local political developments seem to be the cause for more headwinds for the local currency, as well as sluggish economic growth that is showing very few signs of a speedy turnaround. The Reserve Bank might still consider lowering the repo rate later this year, provided that a stable economic environment continues going forward. Local bond yields also rose on the back of a weakening rand, with foreign investors using the opportunity to buy more government bonds at better entry levels. Foreigners were net sellers of SA equities though, with the gold sector shedding almost 9% for the month.

Global bond yields were also under pressure and treasury yields sold off in the US, Europe and Japan. After the Fed hiked rates a further 0.25% earlier in the month, the US 10-year treasury note touched a year low of 2.14% before closing the month just above 2.3%. Fed chair, Janet Yellen pointed to more hikes this year and even raised the 2017 GDP forecast from 2.1% to 2.2%, despite the disappointing housing and retail data that was released through the month.

GLOBAL EQUITIES

ALPHABET

The European Commission (EC – the executive arm of the European Union) **recently fined Google US$2.7 billion for anti-competitive behaviour.** The European Union began its investigation into Google in 2010 after a number of competitors complained that Google's practices put them at a disadvantage. But the regulators didn't formally accuse Google of an antitrust violation until 2015. The commission concluded that, on average, the company placed results from competing online shopping services only on the fourth page of its results. While expectations of a fine were well entrenched, the magnitude has surprised market participants and stakeholders in general, with many suggesting that the EU is hoping to set a precedent with Google. **Apart from the fine, Google has 90 days to respond to the EC's demands for changing its business practices, or face further penalties of up to 5% of the average daily global revenue of Alphabet, its parent company.** From a valuation perspective, the impact of this fine together with the impact on revenue (if business practices are aligned to the EC demands) is estimated to be in the range of US$6 billion - US$7 billion. Alphabet said it will review the decision and consider appealing it. Analysts expect the firm to appeal as: 1) the accusations may be overturned; 2) they may receive a more favourable decision; and 3) it may be an opportunity for the firm to also negotiate a compromise regarding other potentially more costly Android and search ads antitrust cases. According to some analysts, a worst case scenario is if the decision is not overturned and the other cases result in additional fines of up to 10% of its ad revenue, or possibly US$8 billion - US$10 billion. This represents US$15 - US$18 per share. **We believe that most of the downside has been priced into the recent share price performance but negative sentiment could put further downside on the share price in the short-term. Apart from this setback, we expect Google to maintain its leadership in the search market. In addition, the investments in futuristic projects present attractive optionality and therefore upside potential from a valuation perspective. Therefore, Alphabet remains a key long-term holding in our Global Equity Model Portfolio.**

NIKE

Nike reported fourth quarter profits and revenue that topped analysts' expectations, helped by strong sales growth outside the US. Weakness in the US market was more than offset by strong growth in international sales, good cost control, lower tax rates and a reduction in the number of shares in issue. **The group's strong growth in direct-to-consumer sales was another positive that will continue to add to the margin enhancement investment case going forward.** Revenues for the quarter rose 5% to US$8.7 billion and earnings for the quarter were US$0.60 per share, US$0.10 ahead of consensus expectations. Earnings per share grew by 22% year-on-year. **Nike's balance sheet remains strong with US$3.8 billion cash on hand and an additional US$2.4 billion in short-term investments**. For full year 2018, management guided to revenue growth in the mid-to-high single digit range, which they expect to be led by the continued strong growth outside the US. Coupled with controlled cost growth and a decrease in the effective tax rate, Nike expects another year of double digit earnings growth for 2018. However, it is worth noting that the first quarter of 2018 will be impacted by the high base in the prior year due to the Olympics and Euro 2016.

ACCENTURE

Accenture reported third quarter results that were largely in line with expectations. Revenue for the period rose 5% to US$8.9 billion and 7% on a constant currency basis. **Adjusted earnings per share rose by 8%** year-on-year to US$1.52. Group operating margins were flat at 15.5% and free cash for the year-to-date was US$2.7 billion versus US$1.5 billion in the previous period. **Geographically, growth markets (19.5% of revenue) reported the highest revenue growth** of 16% in USD and 13% in constant currency. North America (46.3% of revenue) grew revenue by 3%, while revenue in Europe (34.2% of revenue) grew by 3% in USD and 9% in constant currency. **In terms of operating segments, all segments performed in-line, with the exception of Health and Public Service,** which saw revenue increase by 1% due to timing issues given regulatory uncertainty. **Management guided for quarter four revenue to increase by between 5% - 8%,** reflecting a 0.5% negative currency impact.

LOCAL EQUITIES

NASPERS

Naspers recorded positive results for the year to March 2017, increasing revenue by 19% year-on-year to US$14.6 billion. Businesses outside South Africa contributed 80% of revenues, compared to 77% a year ago. **Revenue in the internet segment, which now accounts for 73% of group revenues (67% last year), was up 29%,** mainly due to Tencent's excellent results and increased profitability of the more mature ecommerce assets. **Tencent's revenues for the year were up 48%** to RMB152 billion with profit up 40% to RMB45 billion. Monthly active users of Weixin and WeChat were up 28% to 889 million. **Ecommerce revenue grew 11% to US$2.9 billion** and trading losses increased 5%. This was a result of further investments into mobile classifieds and online travel. The group's Indian business, Flipkart, remains a leader in that country despite increased competition with the recent entry of Amazon. The Indian online retail market is expected to reach US$50 billion by 2020, and Flipkart has a market share of over 50%. **The video entertainment segment recovered somewhat compared to the previous year.** Aggregate subscribers increased by 15% to 11.9 billion, although there was a lot of down trading with the subscriber mix shifting towards the cheaper bouquets. Revenue for this segment declined marginally to US$3.4 billion (up 7% in constant currency) on the back of a firm dollar and unfavourable change in mix. Increasing dollar denominated costs resulted in trading profit declining by 32% to US$287 million. Despite the growth in ecommerce (16%) and digital segment of the media business, **the aggregate media business saw revenues decrease by 3% to US$588 million.** This small segment continues to face tough macro conditions in South Africa and the continued shift from mature print to digital platforms. Development spend on established businesses declined by 16% ($85 million), while new investment spend (mobile classifieds, India hotels and ShowMax) increased by US$238 million. It is worth highlighting that **Naspers' diversification as a media and technology company is unrivalled, certainly within the emerging market universe.** The group has a proven ability to 'reinvent' itself by investing in favourable long-term themes. We believe that over time, the significant investments into new ventures such as classifieds and ecommerce will pay off for shareholders.

SPAR

Spar reported interim results with group turnover up 12.6% to R47.4 billion and gross margins up by 0.9% to 9.6%. While **headline earnings were up 10.2%,** they were down 0.9% on a per share basis due to increased shares in issuance post April 2016. **The Southern African business,** which contributes 84% to group earnings, **grew turnover by 4.9% while keeping gross margins constant at 8.1%** – a commendable feat considering volumes were down 5.1%. Tops was the best performer again with wholesale turnover rising 8.9%, while Build it grew by 1.4%, reflecting weak consumer demand for building materials and the adverse impact of oversupply in the cement market. **The Irish business reported constant currency sales growth of 1.6%.** However the sharp strengthening of the rand saw a currency translated decline of 12.9%. BWG, the Irish group that controls the Spar franchise in the region, continues to grow market share in the region with **33 new stores opened over the period.** Diversification across regions has been key to growth as the sector faces deflation trends across all customer categories. Gross margins in the region rose to 12.2% (2016: 10.3%), as the group improved chilled and frozen distribution efficiencies. **Spar Switzerland continues to require increased management focus** – the unit experienced an operating loss of R8.3 million over the period owing to underperforming corporate retail stores and a pension cost adjustment of R13.2 million. The group has transferred the MD of Spar's Kwa-Zulu Natal region to take over as CEO, with his main focus being to drive improvement in the retail offering to the same standard as other regions where the group operates – these changes include updated store designs and revised product mix. **We remain confident in Spar's ability to weather the challenging conditions** faced in all three of their geographies – leveraging their competencies in food wholesale and distribution, the constant investment in these facilities will allow the group to drive margin improvement. Additionally, **high cash generation leaves room for acquisitions,** which we expect to augment organic growth.

LOCAL EQUITIES CONTINUED

STEINHOFF

In Steinhoff's interim results to the end of March 2017, revenue was up 48% to €10.1 billion. This was largely supported by the first time contribution of Mattress firm and Poundland (both from 30 September 2016). **Excluding acquisitions, organic revenue rose 7%, led higher by the retail segment, which grew organic revenue by 9%.** In constant currency terms, the retail division grew by 5%. Group operating profit rose 29% to €585 million, once again assisted by acquisitions and currency movements. Excluding acquisitions, earnings (EBIT) rose 15% to €534 million, resulting in a 0.7% increase in margin to 7.8%. Revenue from the household goods segment (62% of group revenue) rose 39%, with adjusted operating profit increasing 13%. The general merchandise segment (31% of group revenue) increased revenue by 79%, with adjusted operating profit increasing 58%. **The African operation was the standout performer within this segment as revenue and operating profit (including the Tekkie Town acquisition) grew 25% and 27% respectively. The performance of the African region was aided by the strength in the rand and the momentum in Pepkor, which reported like-for-like growth of 8% for the period. Pepkor has reported double digit sales and operating profit growth for the 18th consecutive year. From a geographical perspective, Steinhoff now generates 53% of its revenue from Europe, 26% from Africa, 15% from Africa and 6% from Australasia.**

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