MAY 2018

PROSPERITY

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PRIVATE CLIENT SECURITIES

OLD MUTUAL WEALTH

The month has seen emerging markets underperform as the dollar strengthened and the market continues to demand a growing premium from risky assets. US monetary policy remains tightened. The re-pricing of fundamental credit risk in Italian bond markets was a case in point. Political developments in Italy have reignited concerns over the sustainability of the euro project and Italian political risk is likely to remain elevated for some months. Although there has been a weakening of economic momentum in Europe, consensus profit growth estimates remain stable. Provided that profit growth remains within expected ranges, expensive equity markets globally should de-rate in a benign fashion i.e. markets moving sideways in a volatile trading range. US foreign policy is inconsistent and unpredictable and this uncertainty may dent global business confidence. Despite these concerns, we still remain cautiously optimistic in our outlook for equities.

"The Jack and Pony Show" by Chris Potgieter, Head of Private Client Securities

Having spent 10 days between Hong Kong and mainland China during May, I'm in a better position to vouch for the extraordinary impact of the technology platforms owned by Tencent and Alibaba. From the CFA Institute conference in Hong Kong to meetings with local and mainland asset managers, connected people and Tencent's head of strategy, it was clear that technology is transforming everyday life and my understanding and appreciation has grown far richer. The taxi drivers use an app via Tencent's platform, WeChat, to navigate and keep records. WeChat is also used to purchase and pay and provides access to news, information and entertainment. It is the default communications tool for just about everyone. Businesses connect with one another and the consumers' journey through Alibaba and procurement and payments is seamless and well-governed. The locals in Shanghai were no different in their attitude and the intensity of their use of these platforms - from conducting business to living everyday life. The billion+ eyeballs connected to these platforms attract online advertising and promotions although it still seems to be early days. Every provider of services or products to the Chinese consumer needs to be on these platforms. Revenues will continue to grow and people will keep on investing. Net income may go through cycles, but the trend is upwards. Alibaba founder, Jack Ma, and Tencent founder, Pony Ma, remain heavily invested in the fortunes of these companies - in personal wealth and in time and energy. The stakes are high. Their approach to government regulations is pragmatic and collaborative as it has to be. They promote an open architecture approach so that consumers decide, for most part, which services or suppliers reach "page one" on these platforms. It has changed people's lives and connected the world in a very real way. This has been mostly positive for society. These tenets are important to ensure sustainability and avoid the pitfalls of anti-competitiveness, non-compliance or social self-sabotage as seen elsewhere.

Long may the show continue!

ECONOMIC OVERVIEW

Political concerns have dominated markets in recent months. It has mostly been US President Donald Trump throwing his weight around. Tariffs have been slapped not only on China, but also key US allies in Europe and Canada. The US pulled out of the Iran nuclear accord (sending the oil price up), and reportedly cancelled the summit with North Korea's Kim, yet at the time of writing it appears to be back on. But most recently Italy has been the source of market unease. Italy's two populist parties' attempt to form a government, while an anti-euro finance minister was blocked by the Italian president. The issue is not the instability of Italy's government. After all, the country has on average changed government once a year since the end of World War 2. The issue is that Italy is now a key part of the Eurozone (its third largest economy in fact), and any hint that a new government might pull out of the single currency will cause chaos. Unlike 'Brexit', where Britain will continue to use the pound once the UK exits the European Union, an 'Italeave' or 'Quitaly' event would result in the redenomination of all debts, assets and contracts into a new, probably weaker currency.

We saw this movie with Greece between 2011 and 2014, but Italy is much bigger and systemically more important than Greece. It is too big to fail, but also too big to bail out, as is often noted. However, this also means that Italy is much less likely to take the painful choice of leaving the euro (Greece bit the bullet of painful austerity instead of leaving). On the last day of the month, markets breathed a sigh of relief after a second attempt at forming a government succeeded, this time with a less controversial choice of finance minister and a more technocratic cabinet overall. This might not be the last time these concerns bubble to the surface, given that the Italian people are right to feel aggrieved. Italy's economic performance has been dismal over the past decade, and real per capita incomes never recovered to pre-crisis (2008) levels.

Locally, the South African Reserve Bank's (SARB's) Monetary Policy Committee (MPC) left the repo rate unchanged at 6.5%, as expected. While its own inflation forecast was largely unchanged, it noted that the risks were now tilted to the upside, due to the higher oil price, stronger US dollar and the recent bout of capital flight from emerging markets. The SARB expects inflation to peak at 5.5% in the first quarter of next year, after which the impact of the VAT increase will roll out of the year-on-year numbers. Despite the disappointing first quarter growth data, the SARB still expects the local economy to grow by 1.7% this year, while next year's forecast was raised slightly.

While inflation is within the 3% to 6% target range, the SARB does not see its job as done yet. It has succeeded in getting South Africans to believe that future inflation will on average fall within its target range, but most people see 6% as the de facto target, rather than the upper-end of the range. It instead wants South Africans to anchor their future expectations of inflation on the mid-point of the range, and is only likely to cut rates again if its own forecasts show inflation close to 4.5% over the medium term. Further rate cuts are therefore unlikely.

MARKET OVERVIEW

As we entered the historically volatile period of May to November, the month certainly lived up to its reputation as global markets had a rough time dealing with everything from ongoing US tariff talks, Italian political uncertainty and further emerging market turmoil. Notwithstanding these issues, equity markets proved to be quite resilient. The MSCI World Equity Index closed 0.32% higher, after being up as high as 2.6% earlier in the month. China, Japan, Europe and the US followed a similar pattern as markets gave up most of their intra-month gains in the last half of May. South African equities were no exception and suffered an even bigger decline as the rand and other emerging markets were under pressure in favour of safe haven assets. Financials were particularly hard hit as global banks sold off. Deutsche Bank fell to its lowest level on record on the back of the Italian sovereign turmoil as well as a report suggesting the bank is on the Fed's troubled watchlist. Investors didn't like this and risk premiums jumped higher. The US dollar gained almost 2.5% against other major currencies and US treasury bonds also rallied on the back thereof, with the ten-year yield closing at 2.82%, sharply lower from the yearly high of 3.12%. Brent crude oil rose another 6% in May to close at US$77 - US$11 higher from the beginning of 2018. This trend will hurt consumers as petrol price hikes along with rand weakness will eat into disposable income. A highlight for the month was the performance of local resources, with the sector gaining almost 4%, pushing it into positive territory for 2018.

GLOBAL EQUITIES

STARBUCKS

Starbucks reported Q2 2018 earnings that were broadly in line with expectations. Revenue for the period was up 14% from the corresponding time in 2017 at US$6bn. Analysts had expected revenue of US$5.9bn. Adjusted diluted earnings per share for the quarter were US$0.53 in line with forecast estimates and 18% up from the previous year. The closely watched global and US same stores sales for the quarter were up 2%, consistent with recent management guidance. Same-store sales in China grew the fastest, up 4% compared to the previous period. Group operating margin for the period declined 170 bps to 16.2% primarily due to restructuring and impairment charges. In the quarter, the company opened 468 net new stores globally and closed 298 Teavana stores, which brought the total store count to 28 209 across 76 countries.

There are a number of factors that we expect to drive Starbucks to double-digit earnings growth over the coming years. These include increased personalised marketing, a strong loyalty program, introduction of a fresh food offering and an aggressive store roll-out.

Starbucks' management have previously highlighted the growing importance of the Chinese segment to the company. While the Group has already been successful in Asia Pacific, we expect contribution from that region to grow above the current level of less than 20% as revenue from China continues to grow by double digits.

MICROSOFT

Microsoft released Q3 2018 results that beat both top and bottom line expectations. Revenue came in at US$26.8bn, +16% year-on-year (y-o-y) and ahead of consensus of US$25.71bn. Earnings Per Share (EPS) of US$0.95c was up 36% year-on-year and beat consensus of US$0.85c. Highlights include 58% revenue growth across commercial cloud. Gross margins remained unchanged while operating margins grew by two percentage points. Cash flow from operations and free cash flow showed strong growth as well, up 13.9% and 3% to US$12.1bn and US$9.2bn. The company returned US$6.3 billion to shareholders in the form of share repurchases and dividends over the quarter, up 37% year on year.

One of the certain trends within the IT sector over the medium/ long term is the migration from on-premises to cloud services. In our view, Microsoft is the global leader within this sector with its offerings Microsoft Azure and Office 365. Additionally, Microsoft is finding innovative ways for Artificial Intelligence (AI) to enhance existing software suites, critically embedding AI into Office 365 applications to drive efficiencies. LinkedIn, although still relatively small in the portfolio, has the power to draw even more individuals into Microsoft's ecosystem. LinkedIn now has 530 million users.

Integration is the key for Microsoft's long-term success as it adds extended shelf-life to existing software through increasing compatibility and enhancing functionality. We believe Azure and Office 365 are the centre of this. Building Azure's and Microsoft 365's large installed user base will allow Microsoft to continue growing revenue, margins and earnings while tucking in additional functionality and features.

S&P GLOBAL

S&P Global reported solid Q1 2018 earnings. Revenue for the period was up 8% from the corresponding period in 2017 to US$1.6bn. The Group reported growth in each of its business segments, despite weak bond issuance and increased volatility. Group operating margin increased 130 bps to 45% due to improved operating leverage. Increased margins and a lower tax rate resulted in diluted earnings per share rising 26% to US$1.93 for the quarter. During the quarter, the company purchased US$1.2bn worth of stock and paid a dividend of US$127m.

S&P Global's business model allows the Group to earn recurring revenues, maintain high margins and generate high levels of free cash flow in an oligopolistic industry. We believe that these are the quintessential qualities of a great long-term investment.

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.

AMAZON

Amazon reported Q1 revenue and earnings that beat market expectations. Revenue for Q1 was up 43% year-on-year to US$51.04bn, ahead of the median forecast of US$50.17bn. The group reported earnings of US$3.27 per share versus consensus estimates of US$1.22 per share. On a year-on-year basis, profits for the Group rose 54.8%. Operating cash flow, one of our preferred metrics for business health, rose 4% to US$18.2bn.

Online retail penetration in the US is still relatively low at about 9%. We expect the penetration to grow over the coming years and Amazon will continue to capture a disproportionate share of the market in this growing trend. Online penetration in Amazon's international segment presents even greater scope for growth.

Amazon has multiple growth opportunities outside of the current online retail that can become significant profit generators. Amazon Web Services is already one such business. Digital media, brick and mortar stores (Whole Foods) and artificial intelligence (Echo devices) are just some examples that we expect will be meaningful contributors in time.

While margins are currently very low as a result of increased investment, in time, we expect them to increase materially. During the period 2003 - 2010 margins averaged 6% and we see no reason why they should not surpass those levels in the future, given the significant investment management have made on various fronts.

DISNEY

Disney's Q2 2018 results were ahead of expectations, largely due to the strong performance in the Group's Parks and Resorts as well as Studio segments. Revenue for the period was up 9% to US$14.5bn versus expectations of US$14.1bn. Earnings per share was US$1.84 ahead of the expected US$1.70. Cash generation remained strong during the year, with cash generated from operations rising 40% to US$4.5bn. The decrease in the tax rate from the prior year, due to the change in US tax legislation, had a notable impact on the Group's earnings.

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.

IMPERIAL BRAND

Imperial Brands reported interim 2018 earnings that marginally beat expectations, aided by improved volumes and market share within the Growth Brand portfolio (now 63% of total volumes). Net revenue for the period was down 5% to £3.53bn versus consensus expectations of £3.50bn. Excluding currency movements, revenue fell 2.1%. Adjusted earnings per share for the period were down 6.2% to 114.3p versus consensus expectations of 113.9p. On a constant currency basis, earnings were down 1%. Cash conversion for the period was strong, exceeding 110%, while the dividend increased by 10% to 56.87p. Over the half, the Group's dividend pay-out ratio increased from 64% to 68%. Imperial Brands now trades at a forward dividend yield of 7.1%.

Globally, Imperial Brands is the fourth largest tobacco company (ex-China) with large developed market exposure, where there is better cigarette pricing. The Group's large market shares in key European markets provide stable earnings and high margins.

The Group is highly cash generative with a cash conversion rate consistently above 90%. We expect a large portion of future shareholder returns to be generated from dividends due to the Group's current low pay-out ratio and management's commitment to increase dividends by 10% per annum over the medium to long term.

Management's clear strategy of repositioning the portfolio towards high growth brands and reducing the number of brands owned by migration will, in our view, lead to higher margins and a less complex business that will be rated higher by the market.

MEDTRONIC

Medtronic reported full year 2018 results that beat expectations on both the revenue and earnings lines, aided largely by a strong Q4 performance. Group revenue for the year increased 0.8% (4.6% comparable constant currency "CCC") to US$29.95bn while Q4 revenue grew 2.9% (6.5% CCC) to US$8.14bn relative to expectations of US$29.76bn and US$7.99bn respectively. Q4 revenue growth was driven by non-US developed market growth of 4.6% CCC to US$2.71bn and emerging market growth of 15.5% CCC to US$1.23bn. Operating profit on a CCC basis grew 6% to US$8.35bn with margin expansion of 20bps. Adjusted EPS for the year and quarter came in at US$4.77 and US$1.4, signifying growth of 10% and 15% respectively.

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 or move up the income scale and age (as is predominantly the case in developed markets), 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 continues to prioritise therapy innovation, however, also maintains attractive cash generation characteristics. Its 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

VODACOM

Vodacom reported full-year 2018 revenue and EBIT that met and marginally beat expectations respectively. Group revenue grew 6.3% to R86.4bn (+7.8% excluding currency effects). Group EBIT grew 4.4% (+2.8% excluding currencies) to R23.1bn. Net profit grew 18.6% to R15.5bn aided by the Safaricom acquisition (R1.5bn contribution to profit for the eight months since acquisition) and the sale of Helios Towers Tanzania Limited. FY 2018 saw Vodacom Group grow customers by 7mn with South Africa adding 4.5mn and international operations adding 2.5mn customers. Safaricom grew their customer base by 5.1% to 29.6mn. Group customers now total 103mn. Headline Earnings Per Share (HEPS) stayed constant at R9.23, negatively impacted by share issuance for the Safaricom acquisition. The Group declared a final dividend of R4.25, taking the total annual dividend to R8.15, a marginal decline from the previous period.

Vodacom remains our preferred exposure to the South African and African telecommunications sector. In addition to maintaining a strong balance sheet supported by healthy cash flow generation, the management team have shown themselves adept at growing the business amidst an environment of changing regulations and consumer preferences.

The long-term shift from voice to data is well underway and Vodacom has done well to keep pace with timeous infrastructure and network upgrades, increasing coverage and maintaining superior service quality. To this end, Vodacom has become the continent's first operator to reach 80% population coverage on a 4G network.

In line with the shift away from voice, the Group has grown their mobile money business to 32.2mn customers processing a combined US$8.4bn of transactions. We expect the Group to continue growing coverage and awareness of M-Pesa (mobile money), building on the high-teen growth rates observed over FY 2018.

RICHEMONT

Richemont reported FY 18 results which missed estimates largely as a result of inventory buy-backs in the final quarter of 2017. Group sales were up 3% to €10.9bn (+8% at constant currency) while operating profit grew 5% to €1.8bn. Excluding the effects of the buy-back, sales would have grown to €11.18bn and operating profit to €2.05bn, more in line with expectations of €11.12bn and €2.1bn respectively. As a result, operating and net profit underwhelmed, growing 4.5% and 1% to €1.84bn and €1.22bn, respectively. Tight cost control, increased retail sales and lower buy-backs relative to the past allowed operating margin expansion to 16.8%. The Group used the 6.1% growth in free cash flow to increase the FY dividend by 6% to CHF1.9 per A share/10 B shares.

Richemont is the world's second largest luxury goods conglomerate and maintains such illustrious brands as Cartier, Van Cleef & Arpels, Piaget, Officine Panerai and Mont Blanc within its portfolio. Jewellery and watch brands make up over 80% of sales with almost 60% of this being sold from their own retail footprint. More recently, the Group has moved to acquire full ownership of Yoox-Net-a-Porter, the leading online luxury goods retailer, a move which we expect to enhance the reach and diversification of Richemont's offerings in addition to appealing to the fast-growing millennial consumer.

We believe Richemont's strong brand portfolio with enduring qualities will remain relevant and desirable for the foreseeable future. Supported by global wealth creation and the rise of the emerging market upper-income class, Richemont should maintain mid-single digit demand growth together with margin recovery to around 20% enabling the company to continue investing in their brands and growing their presence via alternative distribution channels.

Additionally, a continued recovery in the global environment will support Richemont to continue growing dividends to shareholders (as they have done consistently for almost 10 years). The Company maintains a wide moat provided by their strong brand equity, which has supported, and we believe will continue to support, above cost of equity returns on capital well into the future.

PIONEER FOODS

While Pioneer's interim 2018 headline results saw material gains from the corresponding period in the prior year, due to the low base in the prior year, the Group's results did not meet the market's high expectations. Revenue for the period was down 3% to R9.9bn on the back of price deflation in soft commodities, mainly in maize, wheat and rice. However, volumes were up 4% on the prior year as the Group regained market share in maize, flour and juices. Profit adjusted for the BEE charge was up 36% to R949m, while group operating margin was up 2.7% to 9.6%. Headline earnings per share for the interim were up 26% to 320c, implying that the Group is unlikely to meet full-year consensus expectations of 715c. Management were rather cautious and declared an unchanged dividend of 105c per share.

With the 2016/7 drought firmly in the rear view mirror, we expect Pioneer to disproportionately benefit from the lower soft commodity prices relative to peers due to the company's larger exposure to maize and wheat. We expect material margin improvement in the Group's largest segment (Essential Foods), which will drive group margins as maize volumes improve.

CORONATION

Coronation reported interim 2018 results that were disappointing. Despite revenue growth of 7.4% for the period, group headline earnings per share increased by 1.2% to 223 cents. The weaker-than-expected performance was a result of flat markets during the reporting period, the firmer ZAR and the absence of alpha within key investment strategies. The Group's net fee margin decreased during the interim period to 61bps from 62bps at 2017 full year. Management declared an interim dividend of 223 cents per share, effectively maintaining the Group's trend of paying out all profits as dividends.

Coronation's profitability is mainly driven by two factors – assets under management and fee margin. Over the past few years, these have both been under pressure, but with the cyclical nature of alpha and with seemingly better prospects for the South African economy, we expect these trends to start reversing and to support higher earnings.

SPAR

Spar reported improved interim 2018 results that were slightly ahead of market expectations. This was a continuation of a trend that we saw in the second half of the 2017 financial year, where the Group was making inroads to improve some of the trading challenges they have experienced recently. For the interim period to March 2018, total turnover rose 5.6% to R50bn. Despite competitive trading, the Group's gross margin increased to 9.9% from 9.6%, partially due to the increased contribution from higher margin fresh and perishable products. Group costs were well controlled, increasing 3.8% on a like-for-like basis, which resulted in profit before tax growth of 9.4%. Lower effective tax rates in South Africa and Ireland resulted in headline earnings per share rising by 13.8% to R5.41 cents per share. Management declared a dividend of R2.70, a 12.5% increase from the prior year.

The Spar Group is a well-run and diversified retailer. Apart from the obvious currency benefit of diversification from the Group's offshore operations, the company also operates under different brands, store formats and market segments. We believe this makes the Group more defensive, which we expect to continue to be shown in the Group's margins.

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