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PROSPERITY

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OLDMUTUAL WEALTH

> ***"Growth is never by mere chance; it is the result of forces working together"***
> – James Cash Penney

As 2017 draws to an end, it's important to pause and reflect. This past year has been a tumultuous one for investors as global and local markets were significantly influenced by various economic and political shocks. This month will see the long-anticipated ANC national conference, which will be important in setting the tone for SA business confidence into 2018.

During such uncertain times, investors can easily lose track of the importance of maintaining a long-term outlook; and we all know the damage a hasty response can wreak on a well-crafted investment plan. Yet, it is also important to remember that challenging times can present unique opportunities. At PCS, we remain focused on exploiting such opportunities for your long-term benefit.

Despite the trials of the past year, our business has thrived and this is largely due to your continued support. When we first started PCS, we envisaged a business where clients would find a world class tailored investment capability predicated on global reach, investment prowess and excellent service. Since the appointment of our first portfolio managers four years ago, we have grown our footprint nationally to 23 portfolio managers and currently manage over R10 billion in equities and R10 billion in cash and structured investments on behalf of our clients. None of this would have been possible without having the right people within our business and a strong network of supporters.

On that note, I wish to sincerely thank you for your support. You have been critical to our growth and success and we look forward to working with you in the coming years. I wish you and your loved ones a relaxed, happy and safe festive season and trust that the year ahead will be a prosperous one for us all.

ECONOMIC OVERVIEW

Fitch kicked off the much-anticipated (or dreaded) round of ratings reviews by maintaining South Africa's BB+ rating with a stable outlook. Fitch noted that while the fiscal outlook had weakened, it believed that the ship could be steadied after the ANC's elective conference. S&P Global were not so kind, cutting both South Africa's local and foreign currency ratings by one notch. This means the local rating drops to BB+ and is no longer investment grade, as expected. The foreign rating downgrade was unexpected, and places South Africa on par with Turkey and Brazil at BB, two notches into so-called junk status. Importantly though, S&P has a stable outlook on both local and foreign currency ratings, implying that the worst is over.

This meant the Moody's decision was key. Moody's placed South Africa's rating on negative watch, which means the next move is a downgrade. But the rating for both local and foreign currency bonds remains investment grade at Baa3, and therefore local bonds still qualify for inclusion into the Citigroup World Government Bond Index. Following the ratings announcements, the President instructed Treasury to find additional spending cuts and revenue raising measures to reduce the deficit and stabilise government's debt-to-GDP ratio below 60%. These will be outlined in the February 2018 Budget. On one level, this is encouraging, suggesting a greater realisation on the part of political leadership to ensure longer-term fiscal sustainability. But it is unfortunate that these measures were not included in the October Medium Term Budget, calling into question the coherence of the fiscal planning framework. Perhaps the MTBPS was the cold shower government needed to spring into action. The biggest concern is that austerity measures (cutting spending and increasing taxes) could be counterproductive if it chokes off the nascent economic recovery. Therefore, it is important that they are introduced together with a package of reforms to boost economic growth. All the ratings agencies agree that it is weak growth that is the root of our fiscal problems.

The rand gained 3.5% against the dollar during November despite South Africa being downgraded by S&P Global. Why? Markets respond to the factors that give rise to ratings changes – weak economic growth, rising government debt, financial challenges at Eskom – long before the ratings agencies do. Much of the bad news, including the downgrades, was priced in by the time the agencies made their official announcements. The muted market response to the downgrade reiterates that investors should not over-react to negative news headlines.

MARKET OVERVIEW

It was another good month for US equity markets, with all three main indices ending in positive territory. The Dow Jones Industrial Index ended 3.5% higher, to bring the year to date performance to just over 22%. Supportive economic data, as well as a positive outlook for the upcoming holiday season and optimistic expectations on tax reform gave markets an extra boost as 2017 draws to a close.

European markets were not as upbeat with the effects of Brexit still very much present in UK and European mainland equities, in addition to a strengthening euro that put a lid on most major indices, as French, German and UK equities closed just over 2% lower. Asian markets had mixed results, with Japan, Hong Kong and Australia ending in positive territory but China notably off the pace after reports on concerns over consumer lending in an already debt-fuelled economy.

It was a month to remember for SA bank stocks as the six-member Bank Index recorded its best month since March last year, gaining 8% for November and pushing the index back to positive for 2017. The local All Share Index ended flat for December as positive gains in financials were countered by struggling small caps, industrial and resource companies.

GLOBAL EQUITIES

STARBUCKS

Starbucks reported fourth quarter earnings that were broadly in-line with expectations. Revenue for the period was at US$5.7 billion and diluted earnings per share for the quarter were US$0.55. The closely watched global same stores sales for the quarter were up 2% and adjusted for the hurricane impact in the US, global same store sales would have been up 3% for the quarter. Group operating margin for the period declined 90 bps to 20% primarily due to increased staff costs in the US. In the quarter, the company opened 603 net new stores globally, bringing total store count to 27 339 across 75 countries.

There are a number of factors that we expect to drive Starbucks 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 rollout. 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. The group is highly cash generative and we expect management to meet their target of returning US$15bn to shareholders in the coming three years by way of share repurchases and dividends.

WALT DISNEY

Disney's management previously guided that 2017 would be a year of subdued growth, largely due to the high base in the studio entertainment division in 2016 and the recent US hurricanes. In line with the stated guidance, revenue for the full year was down 1% to US$55.1bn, while operating income fell 4% to $8.9bn. On a comparable basis, earnings per share for the year decreased from US$5.72 to US$5.70 y-o-y. Cash generation remained strong during the year, with free cash flow for the period rising 4% to $8.7bn.

From an earnings perspective, the Parks segment was once again the best performer, largely driven by the Paris and Shanghai Parks. Total Parks revenue for Q4 was up 6% to US$4.7bn and operating income was up 7% to US$746m. The strong performance from the international parks outweighed the negative impact from the closure of US parks and cancelled cruises due to the hurricanes. The impact of the hurricanes was estimated to be about US$100m and more than a 2% hit to operating margins. Looking ahead, 2018 will be important in terms of seeing how well Bamtech and Disney's own direct to consumer offerings perform, starting with ESPN Plus. While increased investment into these platforms will see an increase in expenses through 2018, management believe that this is vital to the future of their media business. The focus will be on generating a high number of subscriptions from the start. More details regarding pricing and the extent of investment will be provided in the New Year.

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 delivered second quarter results which beat market expectations, however, revenue was 4% lower than last year on a reported basis. A significant divestiture in mid-2017 and the impact of Hurricane Maria hampered top-line growth over the period. Adjusting for these, revenue grew 3% on a constant currency basis. The Cardiac and Vascular Group performed well while Diabetes disappointed as expected. US revenues were flat on a like-for-like basis whilst non-US developed market revenues increased 5%, however, emerging markets grew by 12%. The company reiterated FY revenue growth of low-mid single digits and EPS growth in the low teens supported by non-US developed and emerging market growth as well as acceleration in the company's innovation cycle.

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 finally 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 pushing global healthcare demand.

LOCAL EQUITIES

SPAR GROUP

While Spar's full year 2017 results were disappointing, there was a notable improvement in the second half of the year compared to the interim report. For example, South African like-for-like volumes for the full year were up 1.8%. At the interim period, they were down 4.1%, which highlights the sequential improvement. In aggregate, group turnover was up 5.3% to R95.5bn. Gross profit was up 14.6%, while gross margin improved by 82bps to 10.1% thanks to the offshore business which services the higher margin convenience sector. Headline earnings per share were down 6.6% to R9.53 due to the 6.7% increase in the issued number of shares for the Swiss acquisition. The group's dividend was up 1.5% to R6.75.

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. The group is highly cash generative and not capital intensive, which allows them to maintain a generous payout ratio of about 66%. We expect this to continue and to be a significant contributor to shareholders' total returns. The group's model of essentially operating as a warehousing and distribution business that serves its retailers has served the group and store owners well. We believe that there remains room for margins to increase at group level as Spar introduces more Spar branded products and shifts the mix to fresh foods, which command higher margins.

FIRSTRAND

FirstRand, Africa's largest lender by market value, plans to take on Britain's biggest banks with the takeover of Aldermore Group. FirstRand has agreed to buy all of Aldermore after winning the backing of the UK lender's board and its largest shareholder. The offer, which values Aldermore at about £1.1bn, will help FirstRand diversify away from South Africa, which accounts for about 96% of earnings.

Fast-growing Aldermore is among a group of UK banks seeking to challenge the dominance of the nation's four biggest lenders, which control as much as 80% of the market, by offering faster lending decisions and more personalised customer service. FirstRand is also facing increased competition from smaller banks and financial-technology start-ups at home. FirstRand will create a new division for its UK operations which will house both Aldermore and FirstRand's auto-finance business MotoNovo.

FirstRand is offering £3.13 a share for Aldermore. In a recent earnings update, Aldermore showed an improvement in its tangible net asset value to £1.76 from £1.525 at the end of 2016. This values FirstRand's offer at 1.78 times its net asset value. FirstRand needs approval from 75% of Aldermore's shareholders for the deal to go through. The deal will not impact the outlook provided by FirstRand at the release of the full-year earnings in September. Return on equity is expected to be in the upper end of the 18% to 22% target range. The acquisition comes as FirstRand seeks to build offshore funding so it does not need to rely on the South African government's credit rating. The company is able to fund the entire transaction with existing cash resources. Furthermore, management continue to build up excess capital and expects to continue to generate surplus capital post the transaction.

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