NORTHSTAR

ASSET MANAGEMENT

Market Report : Q1 2019

QUALITY INVESTING

THE BIG PICTURE

MINING RESOURCE CYCLE—ARE WE IN THE GREEN, YELLOW OR RED ZONE?

By Adrian Clayton (Managing Director & CIO) and Rachel Finlayson (Analyst)

"For it is, so to speak, a game of musical chairs – a pastime in which he is victor who secures a chair for himself when the music stops" (John Maynard Keynes).

Over the past decade, local resource shares have carried the wooden spoon on the JSE, yet over the past 3 years, the annualised return for the JSE Resource Index has been 7 times that of the JSE Financial and Industrial Index. Such a change in fortunes has catalysed resource disciples into full song. Is this the time to buy resources, or is owning resources a game of musical chairs where most of the players end up without a chair when the music stops?

We take a pragmatic and high level look at a very diverse and complicated industry, appreciating that we cannot consider all its facets here. At the end of the article we summarise our findings in a table.

The bull's argument for owning resource shares:

- Mining is the first stage in the global production value chain of goods and services and thus represents the axis for all value creation.
- Population growth will underpin ongoing demand for commodities.
- Emerging markets continue to urbanise and industrialise feeding demand for commodities.
- 'Reserve replacement values' are falling, implying that the depletion rate for many resources is higher than the degree to which reserves are being replaced.
- 'Reserve sufficiency ratios', being the finite limit of resources, are declining, i.e. global available reserves of various commodities are dropping.
- Every commodity is finite and becoming genuinely scarce to find, consequently, the cost of production should rise over time and so too the price.
- The world's largest commodity user, China, has for the past few years engaged in pollution reducing policies. As part of this strategy, it is seeking higher quality resources.

The bear's argument for avoiding resource shares:

- The capital intensity of the industry is increasing, this entails larger capital risk for shareholders.
- Off a higher capital base, higher commodity prices are needed to sustain returns.
- There is very little value per unit of production, but volume creates cost effectiveness. To achieve profitability demands enormous scale.
- High profit margins, entices increased production, defeating the profit cycle.
- Mining is extremely volatile due to the inability to predict short-term demand.
- Positive industry structure, such as barriers to entry are irrelevant to profitability as producers always behave as price takers.
- All future economic decisions are based on imperfect and incomplete information – even the technical feasibility study on a mine can prove erroneous. In addition, socio-political factors in developing nations, where a significant number of mines are based, such as expropriation without compensation, threaten to undermine entire ventures.

How advanced is the current cycle?

To assess the merits of investing into the current cycle, we follow a process of looking at a mosaic of factors to gain perspective.

Magnitude and duration of rally

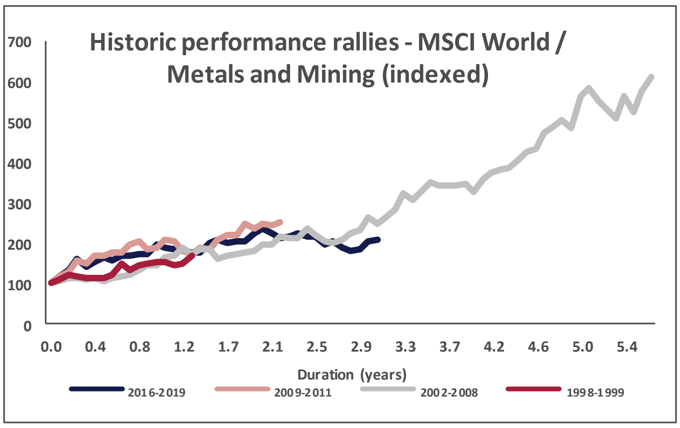

Figure 1. Resource cycles since 1998. Source: Bloomberg and Northstar Asset Management. March 2019.

Since 1998, we can identify 4 commodity cycles:

- The longest lasted 6 years, starting in 2002 – it was long in duration, explosive and considered a super cycle. It failed spectacularly at the onset of the GFC – Great Financial Crisis in 2008.

- Shorter 1 and 2 year mini-cycles started in 1998 and in 2011.
- The latest commodity cycle has lasted 3 years with gains much in line with other mini-cycles.

Neither the length of the current cycle nor its magnitude are obvious points of difference relative to anything seen before it – this cycle's price activity offers limited insight into risks or current opportunities.

Resource prices

Although most commodity prices have been significantly buoyed off their 2015 lows, adjusting these for inflation, shows that prices are not absurdly high. In addition, resources are not a homogenous grouping and performances are quite disparate. Bulks like iron ore have rallied hard while some of the base metals, such as copper, have had more muted results.

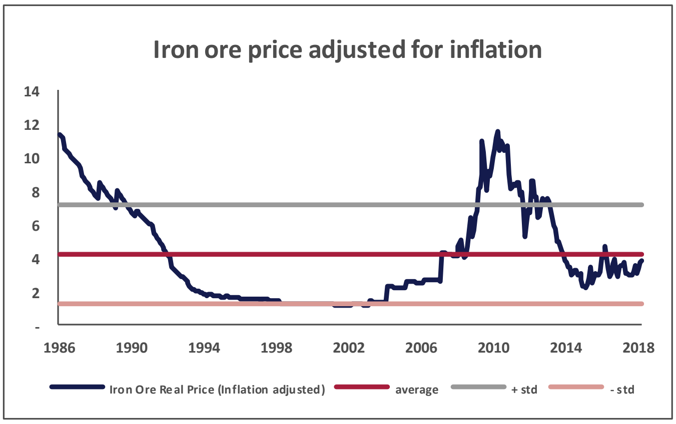

Figure 2. Inflation adjusted price of Iron Ore. Source: Bloomberg and Northstar Asset Management. March 2019.

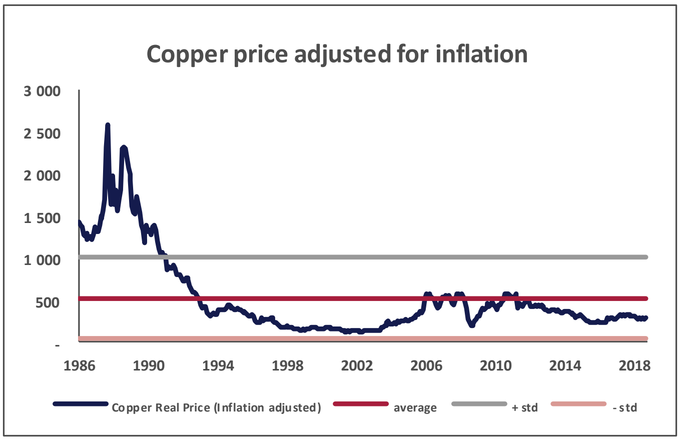

Figure 3. Inflation adjusted price of Copper. Source: Bloomberg and Northstar Asset Management. March 2019.

In nominal terms it is easy to argue that the individual commodity price movements have been significant (iron ore was $37 a tonne in 2015 versus $80 a tonne currently) yet in real terms (adjusted for inflation), the degree of gains are muted.

Company profit margins

EBITDA or profit margins are currently at elevated levels and these margins inevitably mean revert (they return to an average) – mining companies are presently thriving, considering this is a boom and bust industry, we see this as a good reason to be cautious!

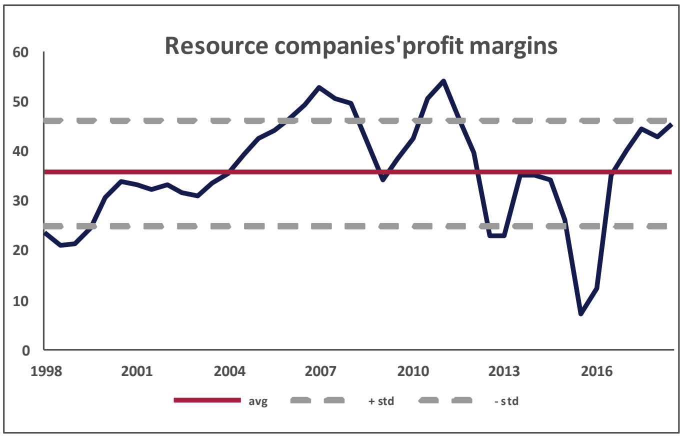

Figure 4. Profit margins of resource companies. Source: Bloomberg and Northstar Asset Management. March 2019.

Returns on capital employed:

The returns that resource companies are earning on their capital employed has reached long-term average levels, thus not incentivising for extra capital commitment and potential shareholder destruction. The risks to returns on capital is a sudden demand shock.

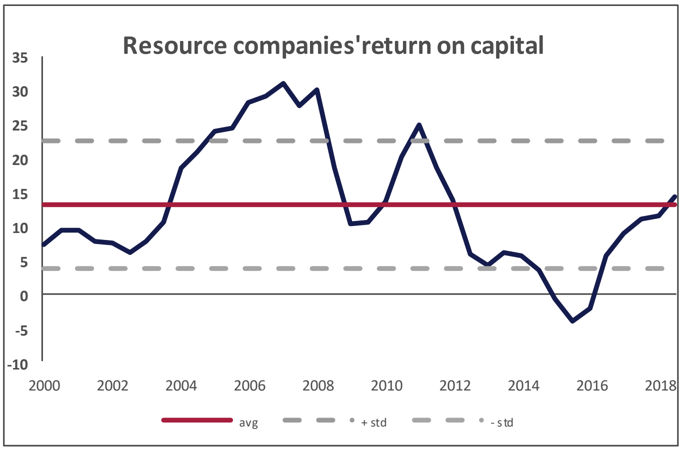

Figure 5. Resource companies return on capital. Source: Bloomberg and Northstar Asset Management. March 2019.

Valuations

One of the many methods we use to value commodity companies (albeit in this case very rudimentary) is price to book. On this metric, the companies do not look expensive. Coincidentally, they also do not look overvalued on cash flow or earnings metrics.

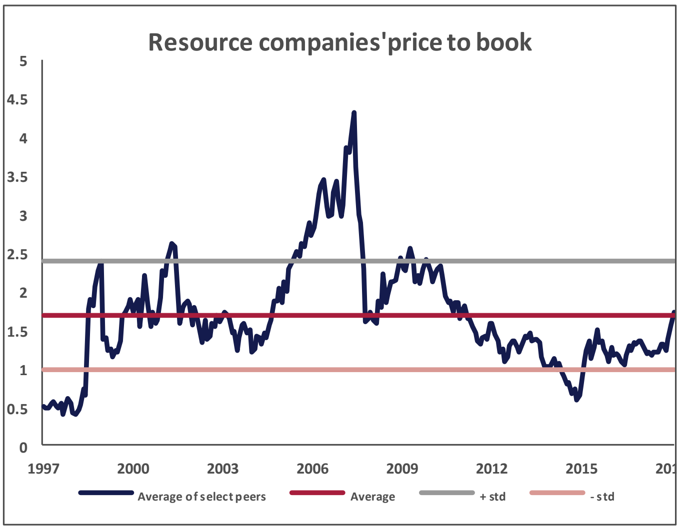

Figure 6. Resource companies price to book. Source: Bloomberg and Northstar Asset Management. March 2019.

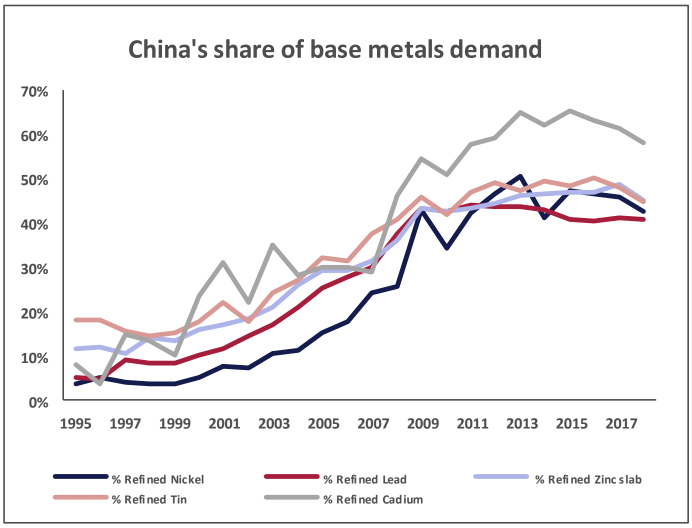

Figure 8. China's share of base metals demand. Source: Bloomberg and Northstar Asset Management. March 2019.

Chinese growth

If there is one lesson we have learnt about investing in commodities it is that predicting short-term demand is a fool's game. China is the dominant global consumer of commodities and affects pricing (see Figure 7 showing Chinese GDP growth against the copper price), so predicting demand, involves predicting China. Demand is predictable over the long-term and is a function of an economy's GDP growth and the intensity of their resource usage and per capita incomes. China should remain elevated on these measures against other countries in the years ahead. Our concerns include the trend in Chinese GDP growth since 2008 and the extent to which the government has had to intervene to keep the train rolling.

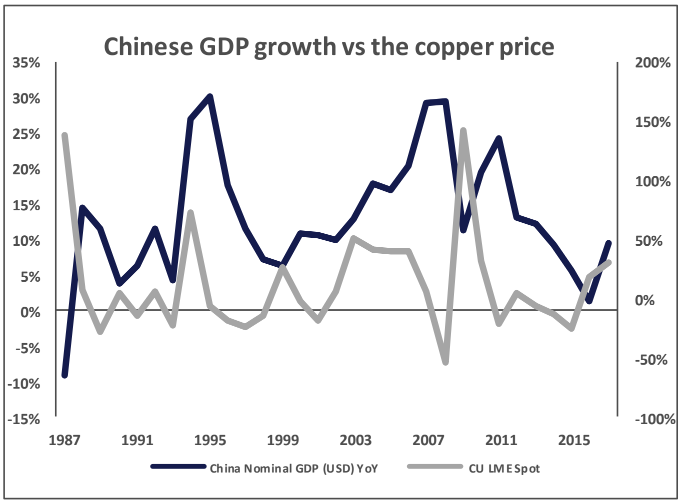

Figure 7. Chinese GDP growth (LHS) vs the copper price (RHS). Source: Bloomberg and Northstar Asset Management. March 2019.

Client dependency

When China accounted for 10% of global commodity consumption in the early 1990's, their growth became a free option to resource companies. Now that China represents at least 40% of resource consumption, the 'white knuckle syndrome' applies to suppliers. We struggle to see another economy that can take the slack in the commodity market if China has an unexpected shock.

Time to buy?

So how far into the game of musical chairs are we? These cycles are enigmatic and in the short-term predictions are a lottery. However, what we know is that the resource industry is one that, with clock-work precision, displays mean reversion. Consequently, the lowest risk opportunity to own commodity stocks occurs when commodity prices are rock bottom and suppliers are generating poor returns off their installed capital bases with weak profit margins. Our work shows that this is not the case at present.

Performance over time

Figure 9 asks the question, even if an investor missed a commodity cycle, in the long-term, does it really matter?

Since 1986, resource returns have lagged the MSCI World Index whilst the risk taken by resource investors has been higher, both in terms of capital draw-downs and volatility.

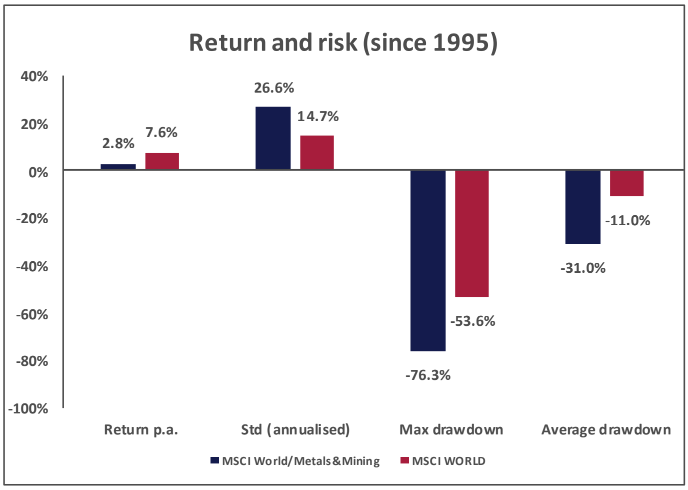

Figure 9. Returns and risk (since 1995). Source: Bloomberg, Morningstar and Northstar Asset Management. March 2019.

Conclusion

Our investment philosophy is 'quality at a reasonable price'. In terms of measuring quality quantitatively, it is evident that relying on a consistent ROIC (Return on invested capital) and FCF (Free cash flow) history in the context of mining, is inappropriate.

We do look to other measures in our quality framework. Commodity companies with proven management teams, that operate at a low point on the cost curve and that possess fortress balance sheets able to withstand the rigors of down cycles, will be considered seriously by Northstar Asset Management as portfolio holdings. However, we remain firmly of the view that commodity investing is about timing and the most opportune time to buy these businesses is when the commodity cycle is in its infancy. We do not believe that is the case currently!

We conclude with a table of our findings from this article.

Factors considered	Green (Safe)	Orange (Neutral)	Red (Unsafe)
1. Magnitude and duration of the rally		X	
2. Resource prices in real terms		X	
3. Company profit margins			X
4. Returns on capital employed		X	
5. Company valuations		X	
6. Chinese growth		X	
7. Client concentration			X
8. Commodity returns over time			X

Table 1. Summary of Northstar Asset Management findings on the commodity cycle. Source: Northstar Asset Management. March 2019.

FROM THE ANALYSTS: EQUITIES

OCEANA — BOUNTY OF THE OCEAN

By Andrew Randles (Analyst)

At Northstar Asset Management we seek to invest in companies that operate in structurally sound industries, which enjoy competitive advantages within those industries, where the management teams act in the interests of shareholders and, that behave in a socially sustainable fashion. It is our contention that Oceana ticks these boxes.

Global fish consumption is rising

Oceana is benefiting from two global fishing industry trends.

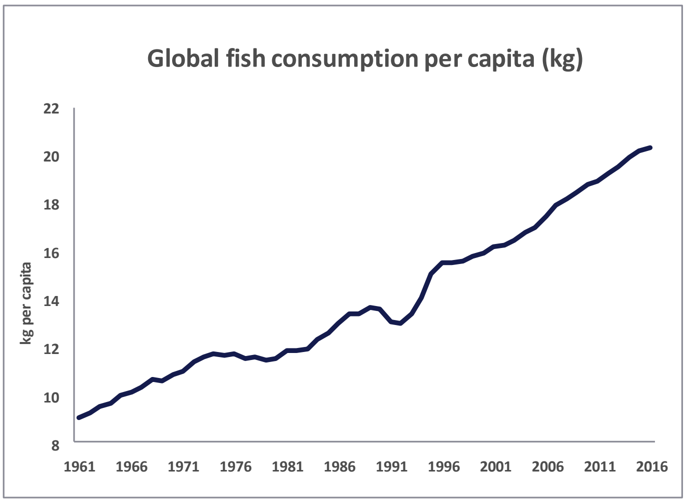

Figure 10. Global Fish consumption per capita. Source: *Food & Agriculture Organization of the United Nations.* March 2019.
Note: Excludes aquatic mammals, crocodiles, alligators, seaweeds, & aquatic plants

The first is that per capita (per person) global annual consumption of fish is rising. This is occurring while natural fish stocks are shrinking.

The consequence of an ever growing demand for this high protein food source and diminishing natural supply, is that fish prices have risen by about 3% annualised since 1990 (FAO Fish Price Index).

The second trend is that farmed fish are filling the supply gap left by reduced wild caught fish. What we show in Figure 11 is that global annual fish production has risen since 1985, but the driver of this has been global aquaculture.

How does Oceana benefit from these two industry trends?

Oceana captures profits via selling their wild-caught fish globally as well as selling fishmeal that has been caught and processed with the intention of feeding other fish.

The ever growing farmed fish population needs to be fed creating a secular demand for fishmeal. Fishmeal (or small fish that are processed and fed to larger fish) have a higher amino acid content in 7 out of the 10 essential amino acids

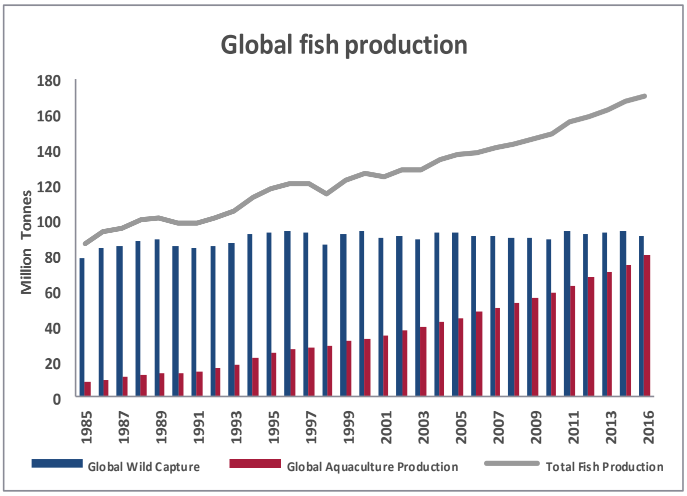

Figure 11. Global fish production. *Source: Food & Agriculture Organization of the United Nations.* March 2019.

for fish feed than plant alternatives, making their inclusion in fish feed essential. Plant alternatives are the only alternatives that can be produced at scale at the moment.

Regulations and licenses – a weak moat, but still a moat

The reality of fish scarcity has prompted governments all over the world to clamp down on overfishing by means of regulation. Governments generally regulate by way of fishing rights coupled with a quota, providing the fishing companies allowable catches, creating a competitive advantage. This competitive advantage for Oceana is reflected in Figure 12, which shows returns on tangible invested capital averaging 27% over the past 28 years.

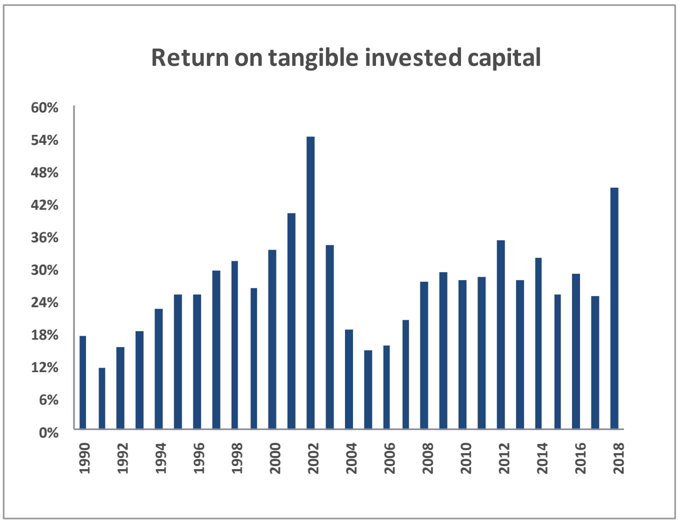

Figure 12. Return on tangible invested capital. Source: Company Reports. Northstar Asset Management. March 2019.

Experienced management

Management has a wealth of experience and a steady hand at the tiller. They recognise that sustainability and close relations with Government are key success factors to ensure their performance is enduring. Oceana has a clear set of 169 defined sustainability targets, 17 aspirational targets and a timeline of 13 years (2030) to achieve these. Oceana also has a B-BBEE rating of 1, critical for retaining licenses.

Conclusion

The long-term growth tailwinds for fishing, the key success factors exhibited by the company and its underappreciation by the market, makes Oceana a business we are comfortable owning in our portfolios.

FROM THE ANALYSTS: EQUITIES

VISA — WHY WE CONTINUE TO LIKE VISA IN THE MIDST OF A DYNAMIC PAYMENTS LANDSCAPE

By Donovan Stefan (Analyst)

Visa is the outright leader in a duopolistic payments industry with market share two times that of its closest rival Mastercard.

Deep strategic competitive advantage and formidable barriers to entry

Visa's ubiquity is indisputable, with over 3.3 billion cards in issue and relationships with thousands of financial institutions and millions of merchants globally. The scale of

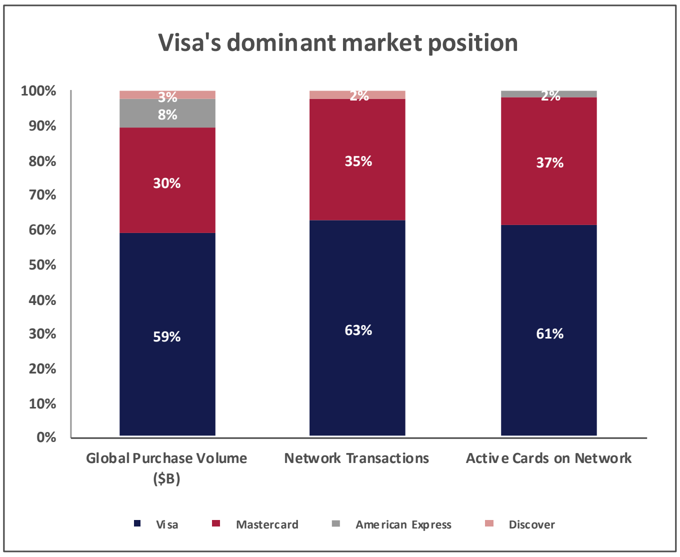

Figure 13. Dominant market position. Source: Bloomberg.. March 2019.

Visa's global acceptance enables thousands of real time global transactions that are reliable, secure and accurate. The powerful network effect from global acceptance has proven to be enormously difficult to replicate by many competitors who have tried and failed or realised Visa's position and instead, chosen to partner them. The nature of Visa's global acceptance creates a virtually insurmountable barrier to entry for new competitors.

Attractive structural industry growth

The market opportunity for Visa remains enormous and should grow rapidly, driven by a long-term secular shift from cash to digital payments. The Consumer-to-Business (C2B) payments market is still only circa. 48% penetrated. Even when this market becomes saturated, there are two adjacent market opportunities which are the Business-to-Business (B2B) and Person-to-Person (P2P) / Business-to-Consumer (B2C) markets to capture that are virtually unpenetrated. The B2B market is only at card penetration levels of 2% and incumbents have only recently begun building capabilities to serve this large market.

Competition and regulation: friend or foe?

The attractive characteristics of the payments landscape such as size, growth potential, low capital intensity and high profitability has inevitably attracted competition as well as the attention of regulators. Some of the most commonly debated threats to Visa and Mastercard's duopoly status stem from increased competition, innovation and regulatory intervention by governments.

Threats from a regulatory perspective are focused on either providing and incentivising the use of alternative payment methods and/or encouraging more competition. That said, there are compelling incentives for governments to work with existing players to encourage the adoption of cashless payments and to grow the market. These include reduced financial crime and increased tax revenues. This will ultimately benefit incumbents and, given the large cash opportunity, regulatory induced competition might result in the market growing faster.

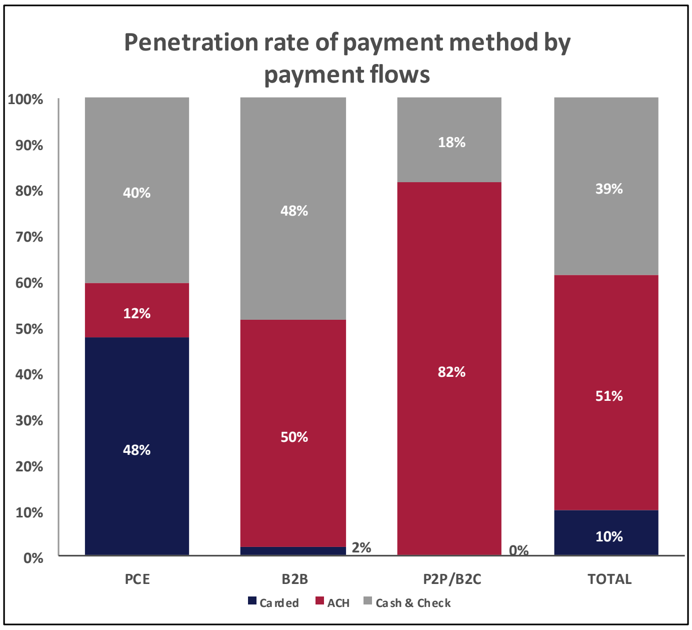

Figure 14. Penetration rate of payment method by payment flows. Source: Mastercard Investor Presentation. March 2019.

The potential re-entry of internet giants like Amazon and Google, and competition in emerging markets where card-based payments are still in their infancy, compared to developed economies, pose competitive threats to entrenched players. This presents an opportunity for new competitors such as Alipay and Tencent Pay to enter into geographies where existing participants are still in the process of entrenching themselves. Having said that, it is important to bear in mind that payment systems/platforms are technically complex, which is often underappreciated.

Many internet giants have tried and failed to disrupt Visa and Mastercard with multiple offerings, often choosing to partner, rather than take them head on. With regards to the emerging market threat, although the landscape will undoubtedly be more competitive, incumbents have the global scale and technical expertise to compete and are steadily growing market share in these regions.

Cash the number one opportunity?

Considering the dynamism of the payments landscape, the aforementioned threats bear close monitoring, despite not posing a near term risk to the market leaders' competitive positions. Ultimately, the long growth runway ahead, driven by a secular shift from cash to digital, means that most competitors and governments, have and will continue to prioritize attacking cash as a means of payment, rather than fighting each other for market share.

In conclusion, we believe that the cash to card secular tailwinds outweigh the increasing competitive dynamics being felt in the industry and consequently, we remain happy shareholders of Visa.

FROM THE ANALYSTS: FIXED INCOME

THE NORTHSTAR SCI FIXED INCOME FUND — MEGA TRENDS WITH MEGA RISKS.

By Mark Seymour (Director - Fixed Income)

The South African economy, although small, has become well integrated into the global economy. The positive implication of this is that it facilitates foreign investment which supports local economic growth. Under Trevor Manual as Finance Minister, South Africa became an attractive destination for foreign capital as a result of tax reforms, fiscal discipline and the liberalisation of exchange controls. The flipside of being globally integrated is that our economy is susceptible to capital mobility which in turn is catalysed by factors such as investor sentiment, changes in economic growth, government deficits, exchange rates, interest rate differentials and relative levels of inflation, amongst other reasons.

To help navigate these dynamics, the SARB implements monetary policy that targets price stability, which ensures that the economy grows in a balanced and sustainable manner. Because of the tight linkages between global economies, it is not surprising that the actions of the Federal Reserve have a large impact on smaller economies such as ours. Figure 15 shows the close relationship between the Fed funds rate and the Repo rate, after applying a lag between the two series.

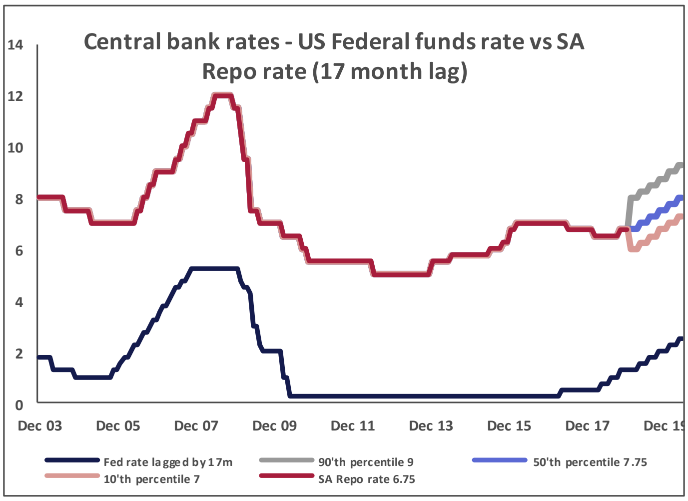

Figure 15. Central bank rates—USA vs SA. Source: Northstar Asset Management. March 2019.

Over the last 15 years, the Repo rate has paralleled the Federal funds rate (17 month lag) with a median gap of 5.5% that has ranged between 4.75% and 6.75% for 80% of the time.

As US interest rates have begun to normalise (rise), emerging market vulnerabilities have begun to show. One of the factors is that emerging markets are running worryingly high twin deficits (of which South Africa is one of the main culprits) and as such have become over reliant on capital inflows to fund these imbalances. As US yields rise, capital has been attracted away from other markets and in many instances, emerging market assets, back into the USA. This leads to weaker emerging market currencies and increased pressure for emerging market central banks to raise rates.

Based on the relationship in Figure 15, the implication is that the SARB should raise rates a further 100bp over the next 12 months. This picture is in stark contrast to the consensus 25bps hike which is penciled in by local participants in our market - seven out of nine contributing economists to Bloomberg are predicting 25bps higher and the money market is pricing in no interest rate hikes.

Although there seems to be a disconnect between the historical trend and how our market is viewing the current interest rate cycle, it is worth noting the positives which could 'make this time different'. These include:

- Ramaphosa's turnaround plan which may translate into a boost in fixed investment;
- Prevailing weak inflation pressures (the rand would need to weaken significantly to push the inflation forecast above the 6% inflation target ceiling);
- The smaller-than-expected current account deficit (2.2% of GDP) in 4Q18;
- The expected improvement in GDP growth in the year ahead;
- Fed officials have begun paring back their interest rate forecasts;
- The European Central Bank has changed their outlook and opted to hold interest rates at record lows for longer than anticipated.

We will add some extra requirements which we believe are important for SA rates to buck the long-term trend, these include:

- SA to avoid a Moody's downgrade on 29th of March;
- Global liquidity conditions to improve;
- Global trade tensions to ease and;
- For the election to go off smoothly.

In the meanwhile, we will continue to apply a margin of safety to all the investments which we hold in our funds whilst actively scouting for opportunities where the market is applying irrational pricing.

CORRIDOR CHATTER

RAMAPHOSA'S HIGH WIRE ACT

By John Steenhuisen (Political Analyst)

Funambulism is the technical word used to describe the art of tightrope walking. Metaphorically it is used to depict a situation where a person is trying to balance two opposing views with limited room for compromise. Nothing could better describe the position that President Cyril Ramaphosa finds himself in currently.

To remain at the helm beyond the election and for the full term of the 6th Parliament, Ramaphosa must continue to walk a delicate line, balancing his ANC party's populist rhetoric and the concomitant policy positions emerging out of their Nasrec conference against not only securing but maintaining the investor confidence necessary to turn South Africa's economy around in order to deliver on grass roots promises.

He must also manage his party's own internal contradictions by getting his entire National Executive Committee, including Ace Magashule and David Mabuza, to sing from the same hymn sheets on key policy positions, in the public arena. Not only does this tussle for the heart and the soul of the ANC threaten Ramaphosa's tenure, but it will also hinder any legislative agenda that Ramaphosa may want to drive in the 6th Parliament. We have just this past month witnessed the manner in which Luthuli House undermined Ramaphosa by flip-flopping on key policy issues. The ink was hardly dry on the President's State of the Nation address when the Secretary General of his party disowned the President's key announcement on the restructuring of the beleaguered ESKOM. This month's spectacular *volte face* on the nationalisation of the Reserve Bank, in stark contrast to the assurances given to the international investor community at Davos, was no doubt driven by the same consideration.

The President has also had his hand forced when it comes to the appointment of sullied stalwarts into key governance positions, such as his placement of the chronically corrupt Mabuza at the helm of the Eskom restructuring ship. The recently released lists of the governing party also don't work in the Presidents favour. They appear to have been entirely dominated by the Magashule faction and by some of those implicated in state capture. This is not a good portent and will make Rampahosa's uphill clean-up battle a great deal steeper.

On the other hand, there are select places in which Ramaphosa can exercise some degree of autonomy. His appointment of the new National Director of Public Prosecutions, Adv. Shamila Batohi, brings new hope to the NPA and can perhaps be viewed as an attempt to rebalance the scales of justice and purge the ANC of corrupt elements over the course of the next few years – something only a strong NDPP can effect. Given the evidence that has emerged from the Zondo commission of enquiry into state capture, it will be important for Batohi to start racking up some high profile prosecutions if the President's claims to fight corruption are to be bolstered.

Key appointments at SARS, the PIC and a host of other bodies and boards are also going to be an important arena for Ramaphosa to stamp his authority on the ship of state. Making the right appointments based on competence and ability to do the job, will go a long way to restoring confidence and accountability. There is no doubt that the President has done a fantastic job in turning around investor sentiment, and succeeded in staving off a previous ratings downgrade. To shift the sentiment into investment, economic growth and sustained confidence, he is going to have to start dealing decisively with some of the fundamental impediments to economic growth. A growing economy, growing jobs and a surge of investment will be Ramaphosa's best antidote to any moves against him. It will enable him to speak to the country over his party and give him a freer hand in moving forward with greater confidence.

STAFF MEMBER PROFILE

TANICHA GRAHAM

By Adrian Clayton (Managing Director & CIO)

Even in a smaller, specialist asset management environment without a huge staff complement, there exists a very busy planning schedule. Northstar has clients, staff, suppliers, shareholders and other related parties that seek interactions with our firm. Tanicha diligently ensures that this occurs effectively and efficiently. She is also very involved in guaranteeing that our clients are cared for in the manner which they are owing.

When did your interest in financial markets start?

- I became involved in financial services when I matriculated in 2015 and joined an advisor practice in KwaZulu-Natal.
- Although I intended studying architecture, I really enjoy acting in an organizational capacity at Northstar and being young, I am giving myself enough time before diving into a tertiary qualification that might prove an incorrect choice.

What did you study and why?

- I am presently busy with my bridging course and once completed will study finance.

What do you think equips you to do this job properly?

- I am organized.
- I understand what our Northstar clients need and how to direct questions to achieve high impact answers.
- I am hard working – I leave home at 6 am to get to our offices early to ensure I'm a steady hand in the busy lives of those at Northstar.
- I share the Northstar ethos that, at the centre of our world, is our client – this approach leaves little to doubt.

What do you love about investing?

- For me it's very real, I often meet our clients in person, what is rewarding is knowing that their affairs are safe at Northstar.

What do you find the most challenging part of your role?

- Our research team and portfolio managers are heavily involved in research and obsess about making our clients' money. Our clients on the other hand do want to see the managers. Trying to balance those two forces is challenging for me.

Why do you think clients will do well at Northstar?

- I mentioned it above, we focus our energies on our clients and prioritize their interests above all else.
- Northstar offers a level of expertise that private individuals do not access easily, elsewhere. Our team manages the monies of individual clients but also institutional mandates – other institutional managers will not manage the affairs of an individual. Northstar provides institutional levels of expertise to individuals.

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Collective investment schemes in securities are generally medium- to long-term investments. The value of participatory interests or the investment may go down as well as up. Past performance is not necessarily a guide to future performance. Sanlam Collective Investments (RF) (Pty) Ltd (the manager) does not provide any guarantee, either with respect to the capital or the return of a portfolio. The manager has the right to close certain portfolios to new investors, in order to manage it more efficiently, in accordance with its mandate. Collective investment schemes are traded at ruling prices and can engage in borrowing and scrip lending. The collective investment scheme may borrow up to 10% of the market value of the portfolio to bridge insufficient liquidity.

Annualised returns are period returns re-scaled to a period of one year. This allows investors to compare returns of different assets that they have owned for different lengths of time. Actual annual figures are available to the investor on request. Income distributions, prior to deduction of applicable taxes, are [included/not included] in the performance calculations. NAV to NAV figures have been used for the performance calculations, as calculated by the manager at the valuation point defined in the deed, over all reporting periods. Investment performance calculations are available for verification upon request by any person. Reinvestment of income is calculated on the actual amount distributed per participatory interest, using the ex-dividend date NAV price of the applicable class of the portfolio, irrespective of the actual reinvestment date. The performance is calculated for the portfolio. The individual investor performance may differ, as a result of initial fees, the actual investment date, the date of reinvestment and dividend withholding tax.

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Foreign securities within portfolios may have additional material risks, depending on the specific risks affecting that country, such as: potential constraints on liquidity and the repatriation of funds; macroeconomic risks; political risks; foreign exchange risks; tax risks; settlement risks; and potential limitations on the availability of market information. Fluctuations or movements in exchange rates may cause the value of underlying international investments to go up or down. Investors are reminded that an investment in a currency other than their own may expose them to a foreign exchange risk.

The terms and conditions, a schedule of fees, charges and maximum commissions, performance fee frequently asked questions as well as the minimum disclosure document (MDD) and quarterly investor report (QIR) for each portfolio are available on Sanlam Collective Investments' website at www.sanlaminvestments.com. Associates of the manager may be invested within certain portfolios and the details thereof are available from the manager.

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