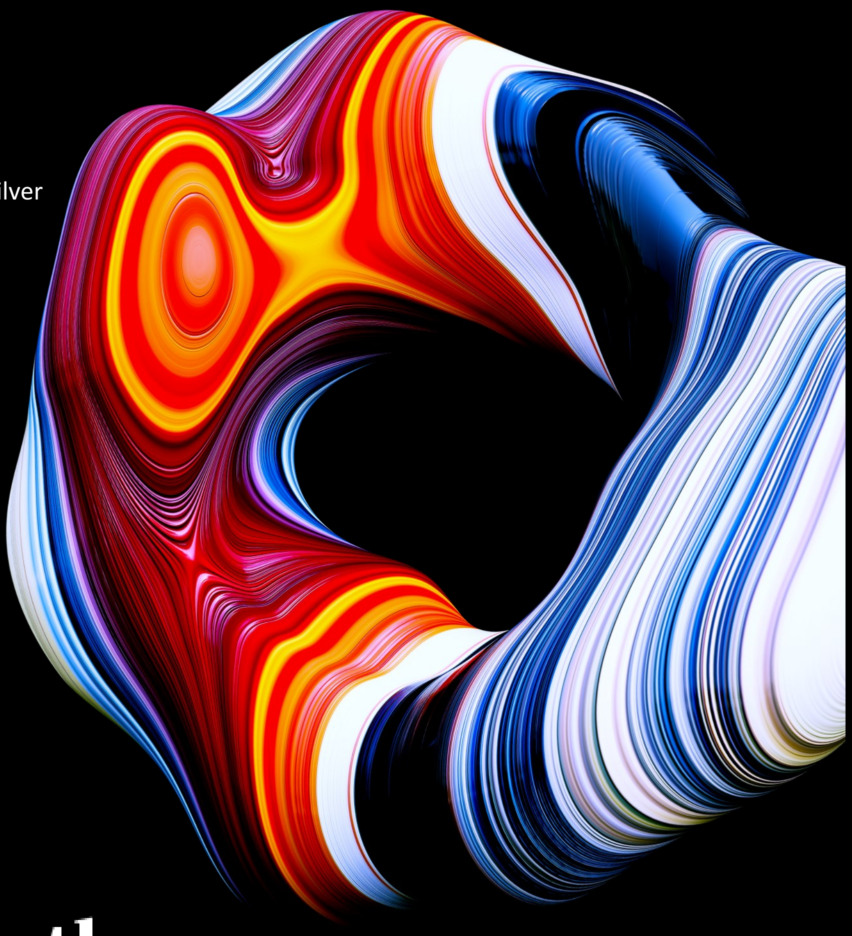
NORTHSTAR

ASSET MANAGEMENT

QUARTER 2 MARKET REPORT



Closer to the truth

THE BIG PICTURE

THE JSE – HORRIBILIS BUT HOPE THERE IS!

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

For investors, professional money managers and company executives, the past five years have played-out as one of the most grueling and painful periods since the 1970's.

This article aims to illustrate how tough the markets have been and we conclude with a very simple reason as to why this has occurred and what it will take for the tide to turn.

Equities against inflation over the last 5 years

Equities offer an outstanding hedge against inflation over the long-term, but lengthy periods of returns below inflation can and do occur. **Figure 1** illustrates the JSE All Share Index's return over 5-year rolling periods against inflation. Each point on the graph informs us of the market's return (blue line) over the past five years relative to inflation (red line). As at 2019, the JSE over the past 5 years has delivered returns well below inflation and these sub-optimal returns rival previous painful periods in 2013, 2003 and the 1970's.

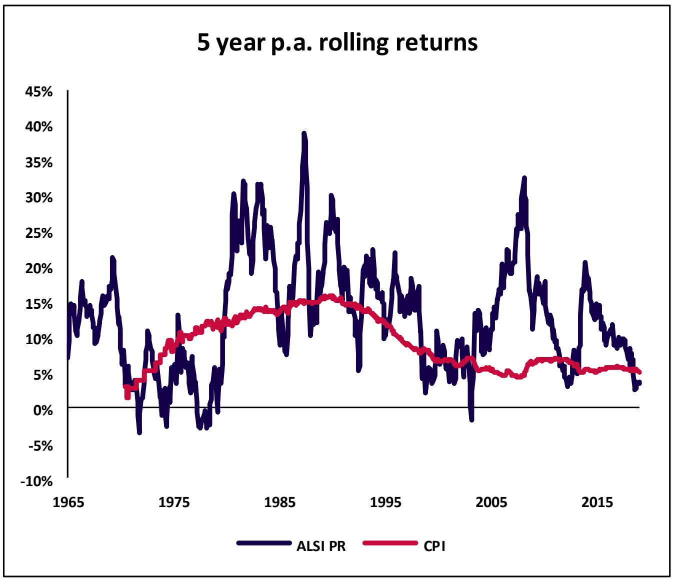


Figure 1. FTSE/JSE All Share rolling 5 year returns vs inflation. Source: Morningstar, Northstar Asset Management. May 2019.

The last decade is a story of two halves

The low returning environment of the past five years is illuminated (**figure 2**) further when we compare the first five years of the past decade to the second five years. The following applies:

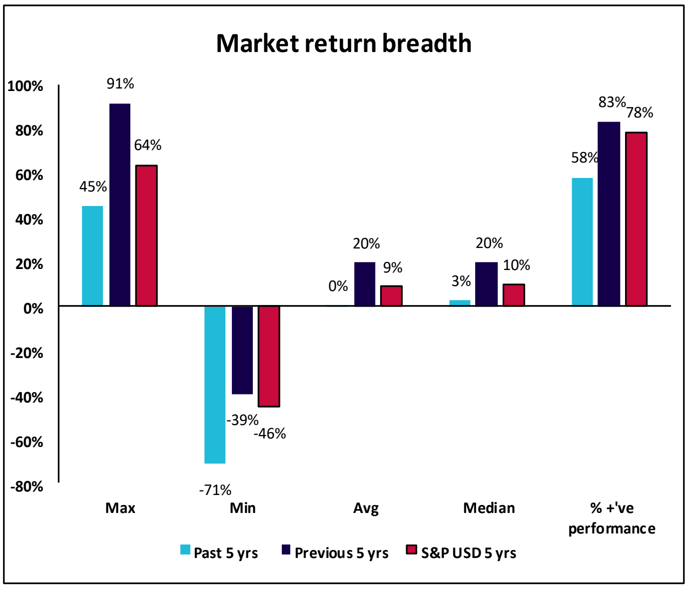


Figure 2.Market return breadth of the last 5 years vs the previous 5 years. Source: Bloomberg, Northstar Asset Management. May 2019.

Best performing stock

The best performing stock on the JSE over the first 5 year period returned 91% (dark blue bar).

The best performing stock on the JSE over the second 5 year period returned 45% (light blue bar).

The best performing stock on the S&P over the second 5 year period returned 64% (red bar – in dollars).

Worst performing stock

The worst performing stock on the JSE over the first 5 year period returned -39% (dark blue bar).

The worst performing stock on the JSE over the second 5 year period returned -71% (light blue bar)

The worst performing stock on the S&P over the second 5 year period returned -46% (red bar).

Average performing stock over the two periods

The average stock on the JSE delivered 20% return over the first 5 year period (dark blue bar).

The average stock on the JSE delivered 0% return over the second 5 year period (light blue bar).

The average stock on the S&P delivered 9% return in dollars over the second 5 year period (red bar).

Number of stocks that delivered positive returns

83% of stocks on the JSE produced positive returns over the first 5 year period (dark blue bar).

58% of stocks on the JSE produced positive returns over the second 5 year period (light blue bar).

78% of stocks on the S&P produced positive returns over the second 5 year period (red bar).

The message in the data is that investors were not rewarded for being invested on the JSE over the past five years. Our equity market has underperformed inflation, other domestic asset classes, most emerging markets and developed markets too.

So what is the main cause of the JSE underperforming?

Companies are not islands, they are living entities that exist and operate within the ecosystem of the economy. Although levers can be pulled by managers of businesses to outgrow the economy in the short-term, this growth rate inevitably converges to the rate of GDP or economic growth (at nominal GDP) in time. Low or no growth economies lead to low or no growth companies and for listed companies, this translates into ailing share prices.

The graph (**figure 3**) shows the extent to which the earnings of companies listed on the JSE follows GDP growth.

Notice two important features of the growth. Firstly, how GDP growth and thus earnings growth have been trending lower since peaking in 2007. Secondly, that GDP growth tends to lead company profitability and considering SA GDP growth has literally, fallen off a cliff of late, it should not surprise investors that forthcoming company results will negatively surprise the market as has been the case over the past quarter.

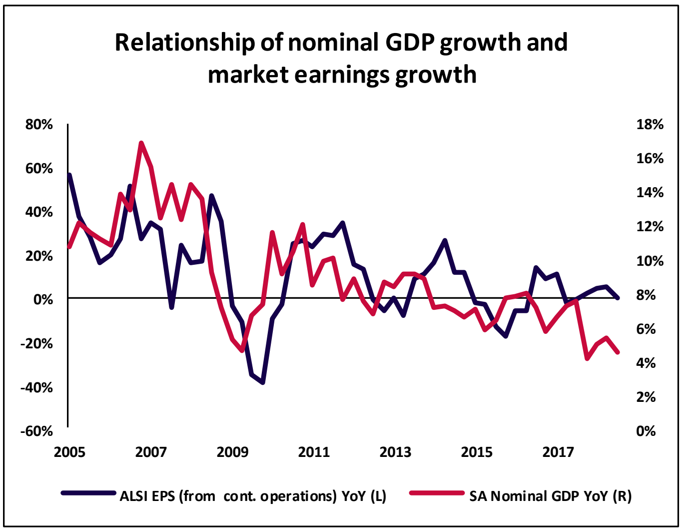


Figure 3. South Africa nominal GDP growth vs market earnings growth. Source: Bloomberg, Northstar Asset Management. May 2019.

Are returns likely to improve?

We indicated that the JSE was showing real value at the end of 2018 and sent our clients a video of our reasoning for this view, since then the local market enjoyed some buoyancy, only to retreat in the past few weeks. Once again, we are noting value building-up on the JSE. However, to sustain higher share prices, company profitability must be fueled and this is contingent upon an improving economic backdrop. We certainly hope that Cyril Ramaphosa and his new cabinet appreciate the gravity of the situation.

FROM THE ANALYSTS: EQUITIES

SHOPRITE HOLDINGS

By Marco Barbieri (Director SA Equities)

Considering our view that there is more pain ahead for corporate profits on the JSE (see our first article 'The big picture') we are not currently rushing out to invest in economically sensitive companies such as domestic retailers. However, share prices have been under pressure for a number of years and our research process continues unabated with a view to establishing attractive entry points into quality companies at reasonable prices. The attached article provides insights into our thinking and investment framework on Shoprite.

Investments Thesis

Shoprite Holdings is Africa's largest FMCG retailer with operations in 16 countries across the continent. It is also the largest retailer within the borders of South Africa, boasting a market share of approximately 32% of all local grocery spend. The group's ability to leverage suppliers, its superior distribution capabilities and structurally higher than industry margins, we believe, will translate into higher than industry returns and market share gains over time.

The South African food retail industry

Size and growth potential

South Africa's formal food retail landscape is an oligopoly with four main operators (Shoprite, Pick 'n Pay, Woolworths and Spar) competing across the LSM wealth spectrum. The market size is estimated to be around R710bn and is expected to grow over the next 4 years (2019-23) at a compound annualized growth rate of 5%.

Competitive dynamics

Shoprite's USave and Pick 'n Pay's Boxer stores are fighting it out in the lower-end of the market, while the more profitable market segment is a battleground for all four main retailers. Woolworths dominates the higher-end market but Shoprite and Pick 'n Pay are improving their fresh food proposition as well as refurbing their stores to be more competitive.

Muted domestic sales growth due to the weak economy incentivised retail management teams to expand offshore and in the most, these moves have been wealth destructive. To mitigate this, a heightened refocus on scooping gains in South Africa has meant fierce competitive dynamics within the home market.

These dynamics together with rising input inflation has shrunk retail profit margins, leading to lower returns on capital as depicted in **Figure 4**.

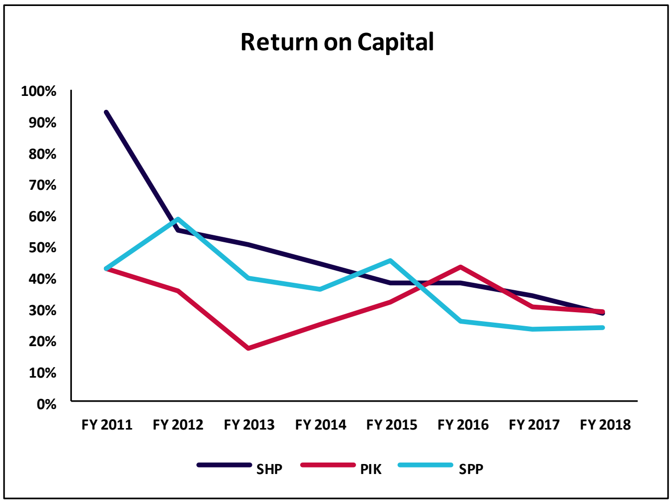


Figure 4. Return on capital of SHP and peers. Source: Bloomberg, Northstar Asset Management. May 2019.

Price takers versus price makers

South Africa's food retail pricing environment is highly elastic (an increase in price reduces demand, or a decrease in price increases demand) with Shoprite, Pick 'n Pay and Spar displaying limited pricing power in their operating markets. There is however some evidence that pricing power exists in the higher LSM categories with Woolworths displaying relatively inelastic demand against peers – this is evidenced by higher margins, **Figure 5**, which, as mentioned above, is increasing competition in this space.

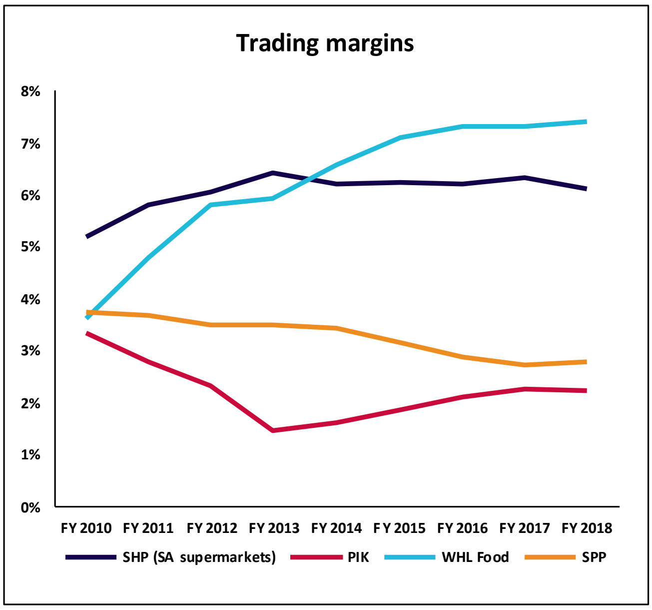


Figure 5. Trading margins of SHP and peers. Source: Bloomberg, Northstar Asset Management. May 2019.

Shoprite's competitive advantage

Shoprite's operating model is based on achieving high volume growth at lower-than-market prices. Continuous improvements of its centralised distribution network, supply chain and sourcing models, drive scale, growth and enhance margins. The business has a clear strategy based on six core pillars, one of which is to grow its LSM 8-10 share of the wallet by enhancing Checkers' brand perception. It is achieving this by improving the fresh food offering, expanding its wellness and convenience proposition and driving innovation. Other opportunities include expanding its private label offering as its penetration is relatively low versus peers, capitalising on the recent rollout of the new SAP retail franchise system and achieving scale in its main African operations.

Shoprite's management

Shoprite's executive management team is relatively new and untested with PC Engelbrecht having been appointed as CEO in 2017 (previously COO) and A de Bruyn CFO in 2018. Investors are skeptical about the involvement of chair, CH Weise, but overall we believe the track record of the board is impressive. We deem the group's strategic targets to be sound and realistic, its overall capital allocation strategy to be adequate and its management of the business to be particularly impressive.

Sustainability

Remuneration

Shoprite's corporate governance is adequate rather than impeccable. The composition and mix of the board is acceptable, however we have question marks over the group's remuneration policy. We regard both CEO and CFO remuneration structures to be adequate, but question the quantum and mix of remuneration to Christo Weise – our benchmark being JSE Top 40 equivalent companies. Furthermore, we feel that management performance measures tied to incentive structures are vague and not directly linked to the important measures of return on capital employed and cash flow metrics.

Social responsibility

Shoprite is well placed from a human and social capital perspective, the business is South Africa's largest employer with a staff compliment of 147,478, having grown by 75,000 over the past decade. It spends significantly on learning programmes and bursaries for its staff as well as being involved in several Corporate Social Investment (CSI) initiatives, including fund raising as well as donating surplus food to charity groups.

One concern is that the group is only a level 8 B-BBEE contributor, but is increasing expenditure on black-owned suppliers and has a diverse staff compliment, 65% being female, and 97% black.

Valuation

We have followed our normal process of establishing Shoprite's true worth at a 'through-the-cycle' level of profitability. We have also, as is conventional for our process, assessed a bear and bull case for the company. Our belief is that the stock is entering a zone which has potential for improving prospective returns to shareholders but considering the state of the South African economy, it is quite possible that we might enjoy the unique opportunity of buying Shoprite for our clients at our bear case valuation.

FROM THE ANALYSTS: EQUITIES

TENCENT—A CLOUD BRIMMING WITH SILVER LININGS

By Simphiwe Msibi (Trainee Analyst)

Life behind the great firewall of China

The number of Chinese internet users has increased at a pace to rival the growth of the overall Chinese economy. Internet connectivity, rising wealth levels and a state party endorsed focus on technology-enabled wealth creation has seen Chinese consumers take to the internet, and internet-enabled media, like fish to water.

Chinese consumers spend about 8 hours a day consuming media, which pales in comparison to Americans who consume about 12 hours of media every day (**Figure 6**). Chinese consumers punch above their weight class when it comes to mobile app usage though, matching the US's almost 3 hours of daily app usage.

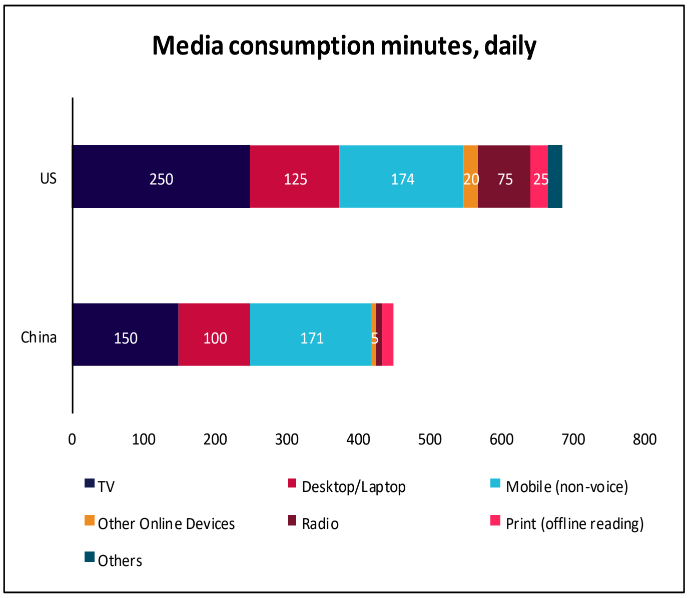


Figure 6. Chinese daily media consumption. Source: CNNIC. Statista. Northstar Asset Management. May 2019

Tencent lays claim to about 51% of those three hours of screen-time for a captive audience of roughly two billion internet users (**Figure 7**). Tencent has not even begun to monetise their user base as aggressively as its US counterpart Facebook, earning about 60% of what Facebook does per user. With most of the firm's revenues coming from in-app purchases on free-to-play games and subscriptions to social services.

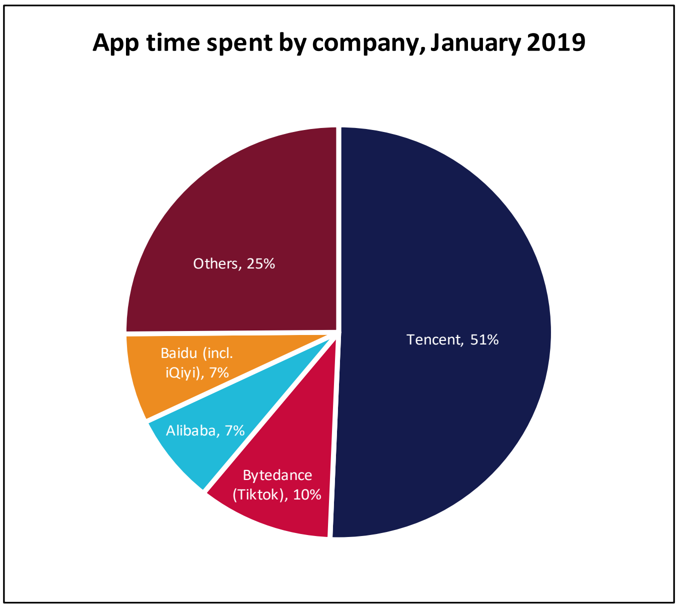


Figure 7. Consumer time spent on apps. Source: TalkingData, iResearch. Northstar Asset Management. May 2019

WeChat super-app ecosystem

At the centre of Tencent's new media empire is their 'super-app' WeChat (**Figure 8**). An instant messaging application wherein users can play mobile games, download music, stream videos, hail a cab, share a snapshot of their day, pay their bills or do some online shopping.

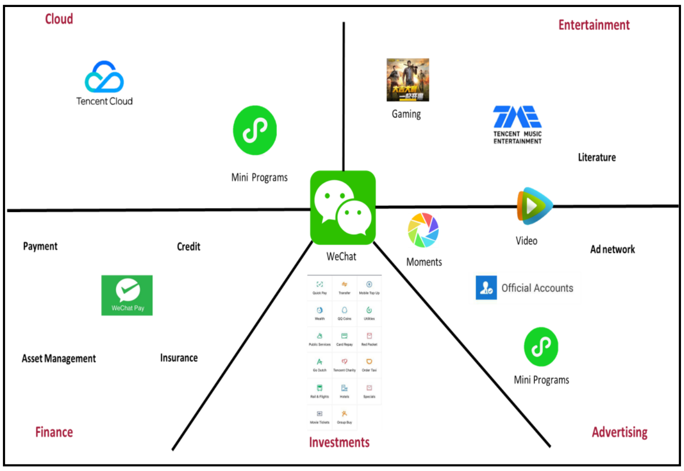


Figure 8. WeChat's ecosystem. Source: Tencent. Northstar Asset Management. May 2019.

WeChat is a classic example of network effects in action (**Figure 9**). Each incremental new user on the WeChat application increases the overall usefulness of WeChat. And as WeChat becomes more useful it attracts even more users, further improving its usefulness.

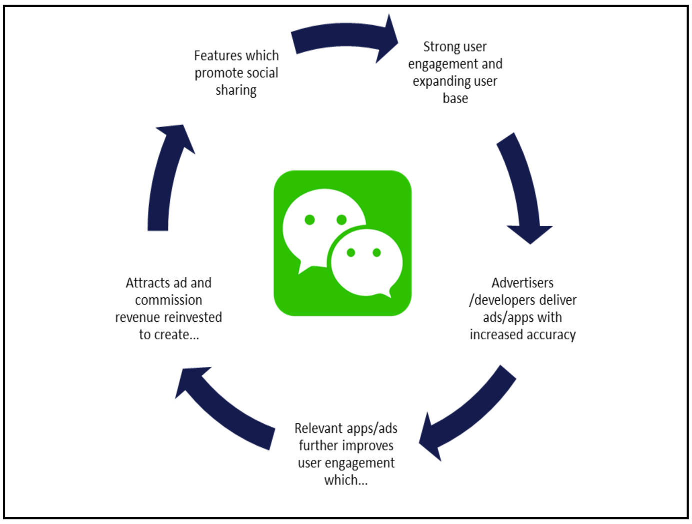


Figure 9. WeChat's virtuous cycle of scale. Source: Tencent, Northstar Asset Management. May 2019.

Tencent then opened up WeChat's network to third party developers, merchants and advertisers who want to sell things to these users, capturing and creating value for both the supply and demand side of the marketplace.

In addition to the entertainment and advertising component of WeChat there is the "industrial internet" (Finance, Cloud and Investments) part of the equation. WeChat Pay is the engine of small to medium commerce in most of China. It is the cheapest method for merchants to accept online or offline payments and removes all friction for users who no longer have to re-enter card info into each app or have to carry a wallet with them for offline transactions. This fuels further adoption of WeChat, evidenced by the 600 million daily transactions completed through their platform and solidifies their 40% market share of total transaction value in China (**Figure 10**).

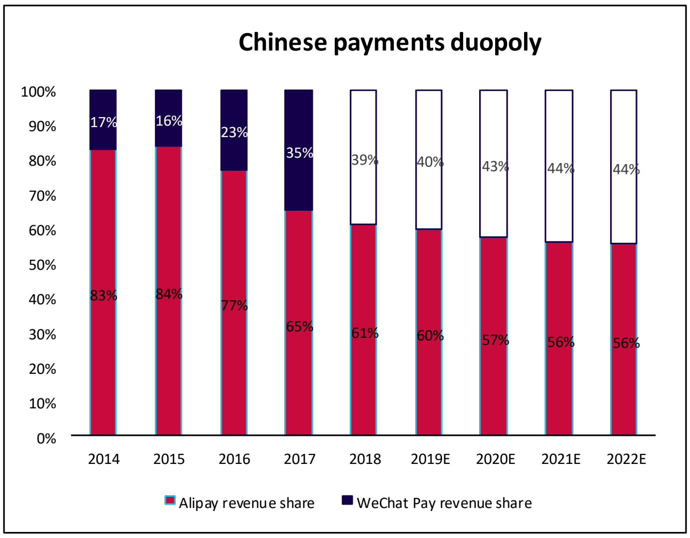


Figure 10. Chinese payments duopoly. Source: iResearch, VISA, Northstar Asset Management. May 2019.

Tencent's ability to monetise its network is not limited to only developers, advertisers or merchants but extends to companies which they have invested in. A prime example of this would be Pinduoduo (PDD), a Chinese ecommerce start-up which was funded by Tencent and launched in 2016. PDD targeted lower income consumers in rural areas by making use of WeChat buying groups which purchase bulk orders of consumer staples for near wholesale prices. Integrating closely with WeChat's ecosystem resulted in rapid adoption and by December of 2018 the total value of all goods transacted had reached $70bn (growing at an average rate of 400% per year) and translating into 5% of total Chinese market share. This makes PDD the fastest growing ecommerce company in the history of Chinese internet and that is almost entirely attributable to Tencent's network.

Consumer services hiccup hints at the larger Chinese regulatory risk

The most recent overhang on Tencent's growth prospects appears to be the same force which propelled its initial growth, Chinese regulations. The impromptu restructuring of the Chinese government's content regulator in 2018 led to an almost year-long stall in the release of Chinese gaming titles, slowing industry-wide growth to 6% YoY, down from 33% the year before. There have been other state interventions into the Chinese gaming industry in recent history and one should not be surprised should another intervention occur.

Chinese regulatory risk does extend beyond temporary disruptions to Tencent's operations. The Chinese technology industry is protected from direct foreign ownership, as such, when one purchases a share of Tencent stock, one is actually purchasing the rights to ownership of a shell corporation which is incorporated in the British Virgin Islands. This shell corporation's only assets are contracts which entitle it to cash flows from Tencent's operations in China (at the discretion of management and the Chinese government). The legal standing of this structure is a grey area which has the potential to be exploited by the Chinese government and could potentially result in a worst case scenario of Tencent's share being worth zero to foreign investors.

We are of the view that this is a real risk but one to which we apply a very low probability given that any Chinese government interventions would impair the ability of Chinese companies to raise foreign capital, which in turn, would materially and irreversibly affect China's overall growth prospects.

A worthwhile investment into a fast growing sector

Tencent is a fast growing behemoth in a structurally sound industry with a deeply entrenched competitive advantage. We believe that Tencent will continue to deliver outsized returns by leveraging its strategic advantage and high adaptability.

STAFF MEMBER PROFILE

DONOVAN STEFAN—ANALYST

By Adrian Clayton (Managing Director & CIO)

When did your interest in financial markets start?

My passion for finance started in my matric year but really ignited in my first year of University when I took a more active interest in personal investments. This led me to altering my career path early on by changing from studying majors in history, economics and law to economics and finance after my first year at the University of Cape Town (UCT). Since then I have not looked back and my passion for understanding the mechanics of financial markets continues to grow.

What did you study and why?

I studied economics honours and then decided to further my passion for financial markets by studying finance masters. I really enjoyed the way economics provided me with a base with which to understand human behaviour and decision making particularly when it comes to financial decisions both rational and irrational. I loved learning how different aspects of the economy and financial markets are interlinked and impact each other.

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

I am a very analytical and detail orientated person which I believe enables me to derive conclusions based on well thought out analysis. I believe my ability to remain calm and not get attached to my investment recommendations helps me to remain as objective as one can possibly be which is critical in a profession filled with emotional decision making. I also believe that my ability to deal with uncertainty and adversity allows me to thrive in a role that is constantly subjected to an ever changing and unpredictable environment.

What do you love about investing?

I love that the investing environment is both very dynamic and challenging. As an analyst, I am continuously learning and trying to piece together how multiple different component parts affect each other and the investment thesis as a whole. Being an analyst is like trying to solve a continuously changing puzzle which is very stimulating.

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

The most challenging aspect of being an equity analyst is having to deal with a constantly changing environment and ensuring that one makes the most informed recommendations in the face of increasing amounts of information, most of which can be irrelevant market noise. The fact that our decisions can have massive consequences for the livelihoods of our clients adds to the pressure of being an analyst – this is why we take our roles so seriously!

Why do you think clients will do well at Northstar?

In my time at Northstar I have learnt that there is a very client centric culture whereby every decision and action we make on a daily basis involves placing our clients first and foremost. In addition, Northstar fosters a research rich environment that allows analysts to do their jobs to the best of their abilities which ultimately benefits Northstar clients.

NORTHSTAR ASSET MANAGEMENT

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