NORTHSTAR ASSET MANAGEMENT

Market Report : Q3 2018

QUALITY INVESTING

In our 3rd Quarter Northstar Market Report Rachel and I discuss investing styles and how these perform within different economic cycles. We provide insights into where we believe the current global economic cycle is at and why our approach of owning under-priced quality companies is safe for our clients. Marco and Simphiwe cover Vodacom, emphasizing the stability of the firm while Rory takes us back to the 3rd quarter of 2017, when we believed Apple was under-priced and how our view, after the stratospheric rise in the share price, has now changed. John Steenhuisen writes about the 2019 elections with a crisp reality check and we conclude by introducing one of our senior analysts, Andrew Randles.

THE BIG PICTURE

STYLE INVESTING—WHAT WORKS, WHEN?

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

Defining the various styles

There are many investing styles. To recognise a style, one can look at the factors an investor considers key before allocating capital to an opportunity.

Typical styles include '***value***' where the dominant requirement would be companies that can be bought below replacement value, in other words companies are sought that are priced on the market at less than what it would cost to rebuild these businesses. Another is '***growth***' and by definition, growth investors gravitate around growth factors such as sales and earnings growth with less emphasis on how expensive the company is today.

A third is '***momentum***', a style diametrically opposed to Buffett's concept that investing is about buying into a real living business. Momentum places little to no value on the business credentials of a company but focuses instead on share price movements. These investors want to own companies with rising share prices and avoid those where prices are flaying.

The final main stream style which you will hear about is '***quality***'. Traditional quality money managers seek companies that have low levels of debt, have stable annual levels of profitability and have a history of delivering excellent returns to their stakeholders.

Northstar uses the best of quality and value

Northstar has always centered its approach on quality but with a critical tweak - '**Quality at a reasonable price**'. We have ascertained that the above styles have attributes which, if blended cleverly, produce better results than their stand-alone performances. Northstar will never buy into a low quality business, which is typical of a value manager. We will also never be drawn into owning a quality company that is over-priced. Our approach is one of finding quality companies that are underpriced.

Styles and economic cycles

With the definitions behind us, the balance of this article is dedicated to Northstar's research conducted on the performance of the value style versus the quality style in varying economic climates. We finally conclude with a stab at where we think we are in the global economic cycle.

We have divided a typical economic cycle (Table 1, over page) into four underlying seasons – recession, recovery, expansion and slowdown. Against this, we have shown how each style has performed historically during these economic seasons. The following are our observations:

- There is a strong relationship between the performance of value companies and improving economic conditions.
- We believe this occurs because weak (value) companies require macro-economic conditions to drive their profit levels rather than their own core internal strengths. As an example, commodity companies are price takers and do well in a pick-up in global growth.
- Value stocks are generally, in our opinion, lower quality businesses requiring a larger risk appetite if acquired. Risk taking is higher in economic upswings.
- Quality does significantly better in recessions and periods of slowdown. Profitability in these companies is more dependable due to their economic moats and they are less cycle dependent.
- Quality businesses generally have fortified balance sheets. They are simply less risky and in risk averse climates, investors seek solace in them.

	Recession	Recovery	Expansion	Slowdown
MSCI World Quality outperformed MSCI World Value	69%	42%	33%	73%
MSCI World Quality underperformed MSCI World Value	31%	58%	67%	27%
MSCI World Quality outperformed MSCI World	77%	42%	33%	87%
MSCI World Quality underperformed MSCI World	23%	58%	67%	13%

Table 1. Investment styles and economic cycles. Source: OECD (2018), Composite leading indicator (CLI) (indicator). doi: 10.1787/4a174487-en (Accessed on 06 September 2018).

Where are we in the economic cycle?

We believe we are nearing a slowdown in the economic cycle. Our reasoning for this is highly detailed but in broad terms:

- Monetary and fiscal expansion has been the agenda of most governments since the 2008 global financial crisis and in the most part, this has now been achieved.
- Central banks are now raising interest rates and yield curves are flattening, indicating a slowdown.
- The US economy is at full employment and the Federal Reserve Bank (Fed) is determined not to be behind the curve. The Fed is the global default interest rate setter.
- Inflation is rearing its head in pockets and central banks are responding to this.
- Some leading indicators are pointing to a slowdown ahead.

Should history repeat itself, quality will outperform value if our contention of an economic slowing materializes. However, many quality companies have become very expensive with concomitant risk of capital loss. Consequently, the most sustainable and profitable investment destination for our clients will be quality companies, which we identify as underpriced. Quality at a reasonable price rather than quality at any price remains our core proposition in all economic climates.

FROM THE ANALYSTS: EQUITIES

VODACOM

By Marco Barbieri (Director - SA Equities) and

Simphiwe Msibi (Trainee Analyst)

Vodacom is a perennial constant in an otherwise uncertain environment

Regulatory headwinds and changing consumer trends have negatively impacted the South African mobile telecommunications sector with all four operators feeling the effects of a sector-wide de-rating over the last year. While investors have become increasingly negative and are likely to apply a higher risk premium in valuing these businesses, we feel important company specific characteristics are being neglected.

We are of the view that there is quality to be found in the telco space and Vodacom is the perfect example of a consistent high quality business operating at a scale advantage to competitors.

Vodacom's leading market position stems from scale and the quality of its network

South Africa's mobile telecommunications industry has been in a state of flux over the past few years and although competition has been intensifying, Vodacom has been able to successfully defend market share (Figure 1). Recent consumer surveys (Figure 2) highlight that Vodacom's higher consumer satisfaction and lowest likelihood of switching scores, relate strongly to the quality and coverage of its network and not solely to product pricing. In fact, SA consumers have increasingly shown a low propensity of switching away from Vodacom in light of its perceived higher pricing versus peers.

In a world where data demand is surging, network quality in

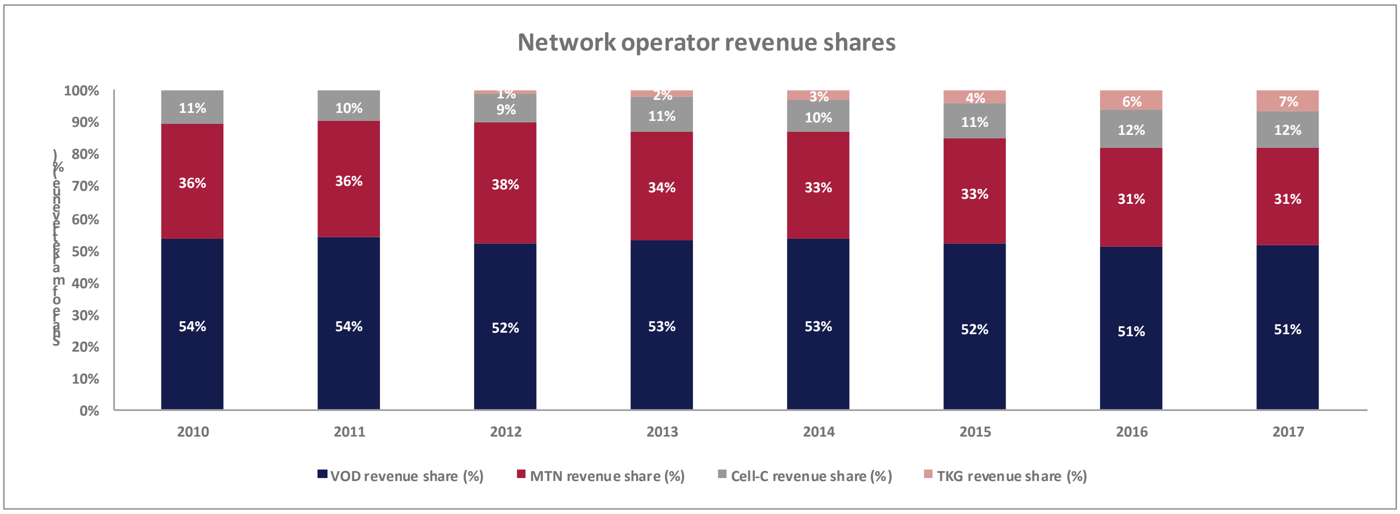

Figure 1. A high value subscriber base translates into market dominance. Source: Company Financial Statements. Northstar Asset Management.

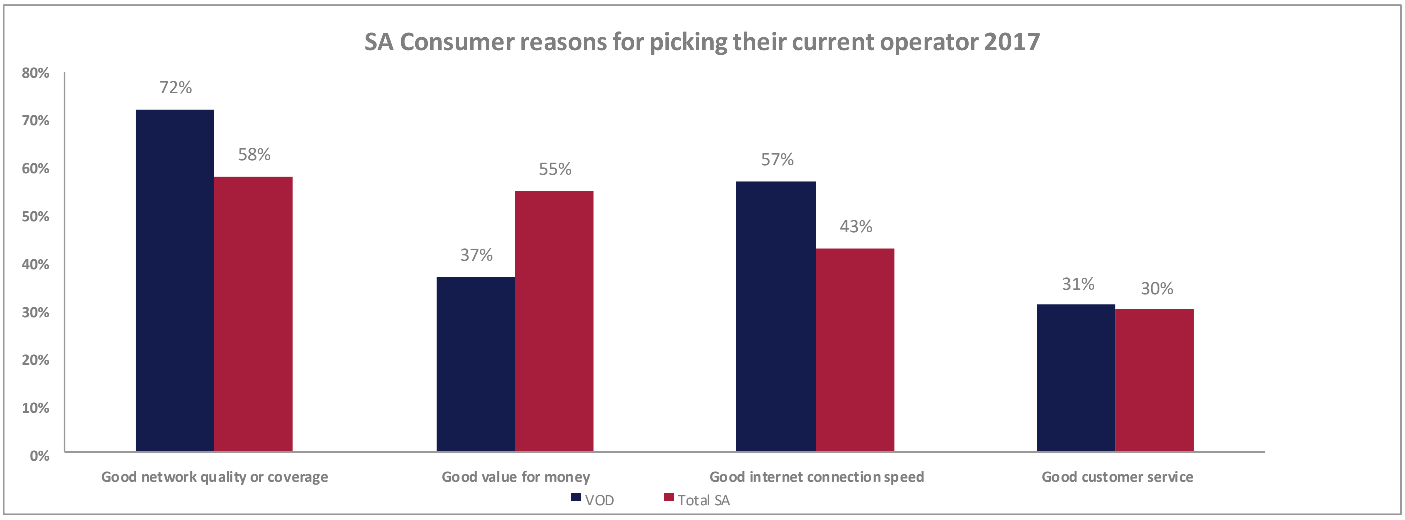

Figure 2. Network *quality is of the utmost importance and Vodacom has attracted the most discerning subscribers. Source: UBS Evidence Lab.*

our view is becoming an even more important differentiator and enabler for telcos to maintain and grow subscribers. Vodacom's market dominance has been a combination of strong strategic execution, scale advantage and a sound value proposition as evident from the company's higher returns on invested capital (ROIC) relative to sector peers (Figure 3).

The way forward as data prices fall

While data demand has been rising, the industry has experienced an overall contraction in service revenue as data prices have been cut by operators. Although higher price competition and regulatory pressures have depleted industry returns over the past few years, we believe data volume will start growing ahead of pricing tariff reductions as consumer data requirements surge. Increased use of instant messaging, streaming and other value-added services will in our opinion drive strong data growth over the next decade.

Among South African operators, Vodacom has been particularly good in capturing new subscribers (Figure 4), having added approximately five million new SIMs to their network in 2017, and is set to add a similarly large number of new SIMs into 2018. We believe Vodacom's scale advantage and network quality will enable it to capitalise on these market trends and continue to deliver strong returns over the medium term.

Valuation

We believe Vodacom is attractively priced at current levels, trading at a 20% discount to its long-term average forward EV-to-EBITDA as the share price, in our opinion, is discounting an overly bearish scenario. Furthermore, the business is highly cash flow generative and we see significant upside based on our discounted cash flow valuation.

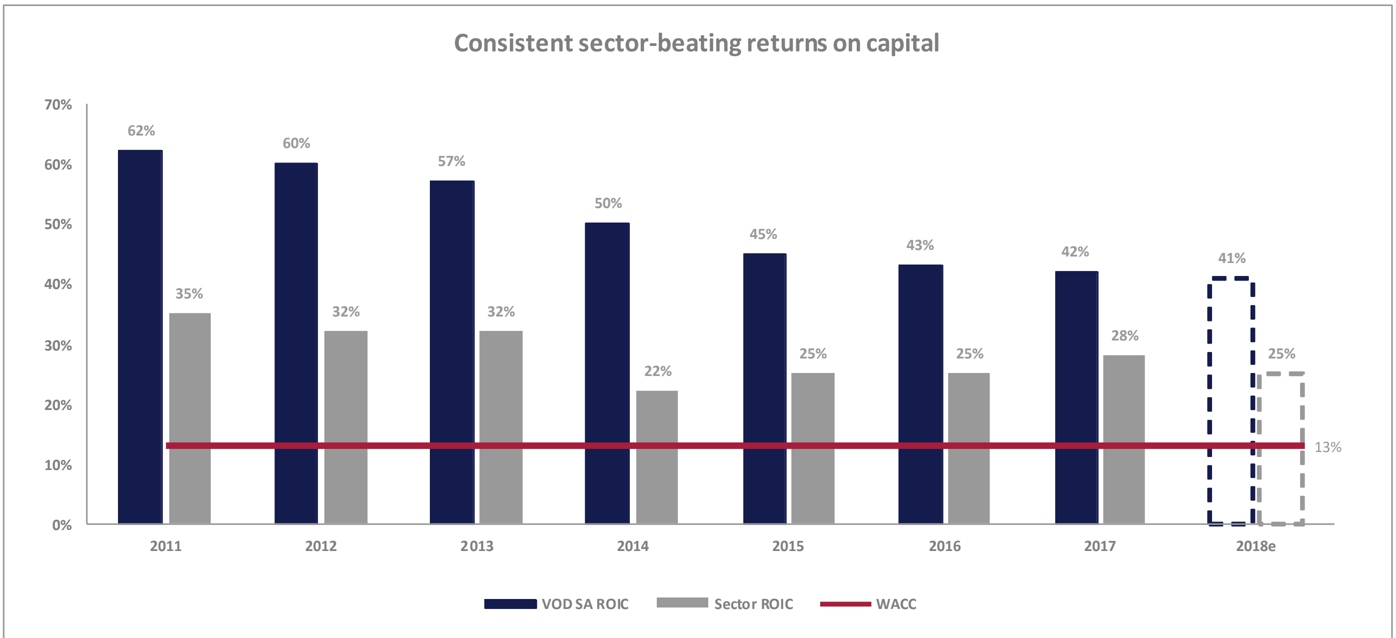

Figure 3. Consistent sector-beating returns on capital. Source: Company Financials. Northstar Asset Management.

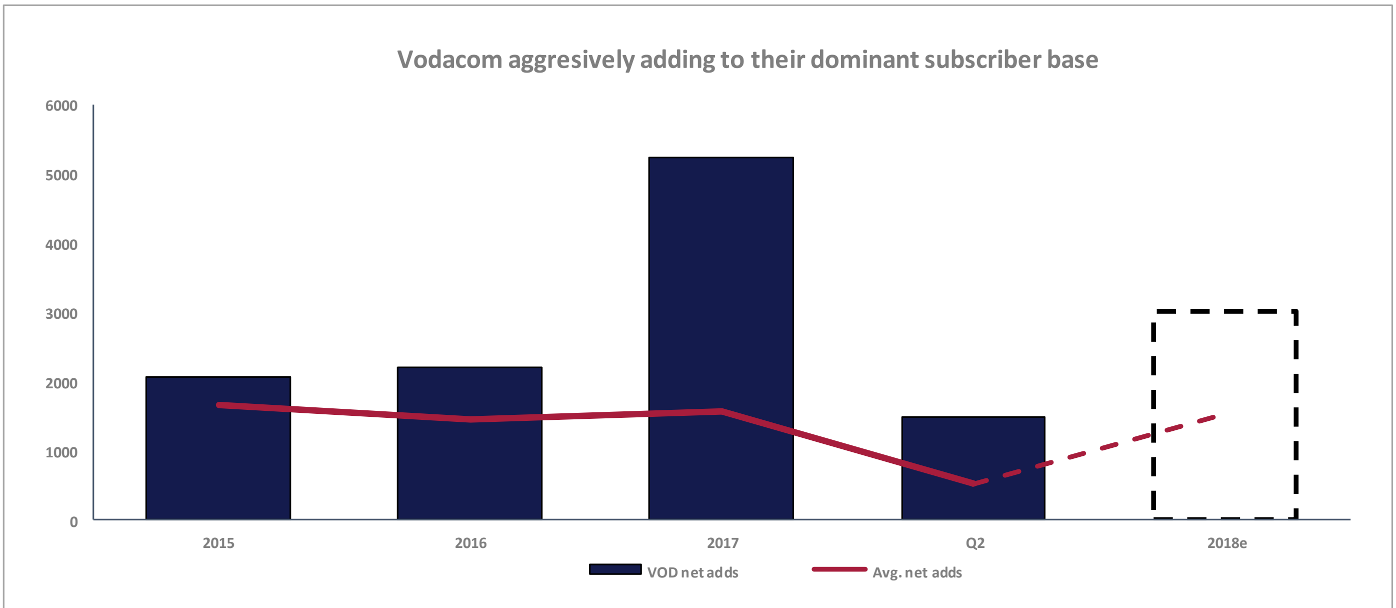

Figure 4. Vodacom has been aggressively adding to its subscriber base. Source: Company Financials. Northstar Asset Management.

FROM THE ANALYSTS: EQUITIES

APPLE

By Rory Spangenberg (Director - Global Equities)

In the **3Q 2017 Northstar Market Report** we highlighted our focus on free cash flow (FCF)[1] as one mark of superior company fundamentals. We also showed how we could discern the market's implied *in perpetuity FCF growth* expectations for a particular company from the current share price and how this provides a useful shorthand or high level approach to valuation.

Apple Inc. and Gilead Sciences Inc, the two companies referred to in the article, have experienced differing fortunes over the subsequent twelve months and so we thought it would be useful to revisit the premise in these examples as an illustration of Northstar's disciplined approach to valuation.

Gilead falls short of market expectations

Recall we sold our clients' entire holding in Gilead at $85 per share in early September 2017, premised on our view that the FCF growth rate required to satisfy market expectations at the time was likely to prove too challenging.

And so it has proved to be – FY18e FCF looks set to decline by 21%, leading to a share price return since our disposal of -11%.

Apple valuation proves conservative

Readers will also recall our decision to retain exposure to Apple, albeit at reduced weights across client portfolios. We highlighted the "peak pessimism" evident in Apple's forward FCF Yield of 15.1% at a share price of $91 in April 2016, which sparked a rally to $160 by September 2017.

Exposure to Apple across our client portfolios had peaked at 6.8% at the end of 1Q 2017, a point at which Apple traded at $143 per share, inline with our Base Case intrinsic value estimate of $144.

While Apple consistently traded above our Base Case valuation from this point, the benefit of our scenario approach to valuation is evident, in that we could rely on our alternative or Bull Case scenario, giving more credence to higher handset shipments and average selling prices, and which resulted in upward revisions to Apple's FCF forecasts as well as our own intrinsic value estimate.

Recognising that our initial estimates were proving too conservative relative to the quarterly results Apple has reported over the past year, we have nevertheless acted prudently, by continuing to reduce exposure, as the margin of safety to even our most bullish estimates has shrunk.

We sold our clients remaining holding in Apple in early August at $208.30, confident that the information and guidance revealed in the most recent results are fully reflected in our valuation.

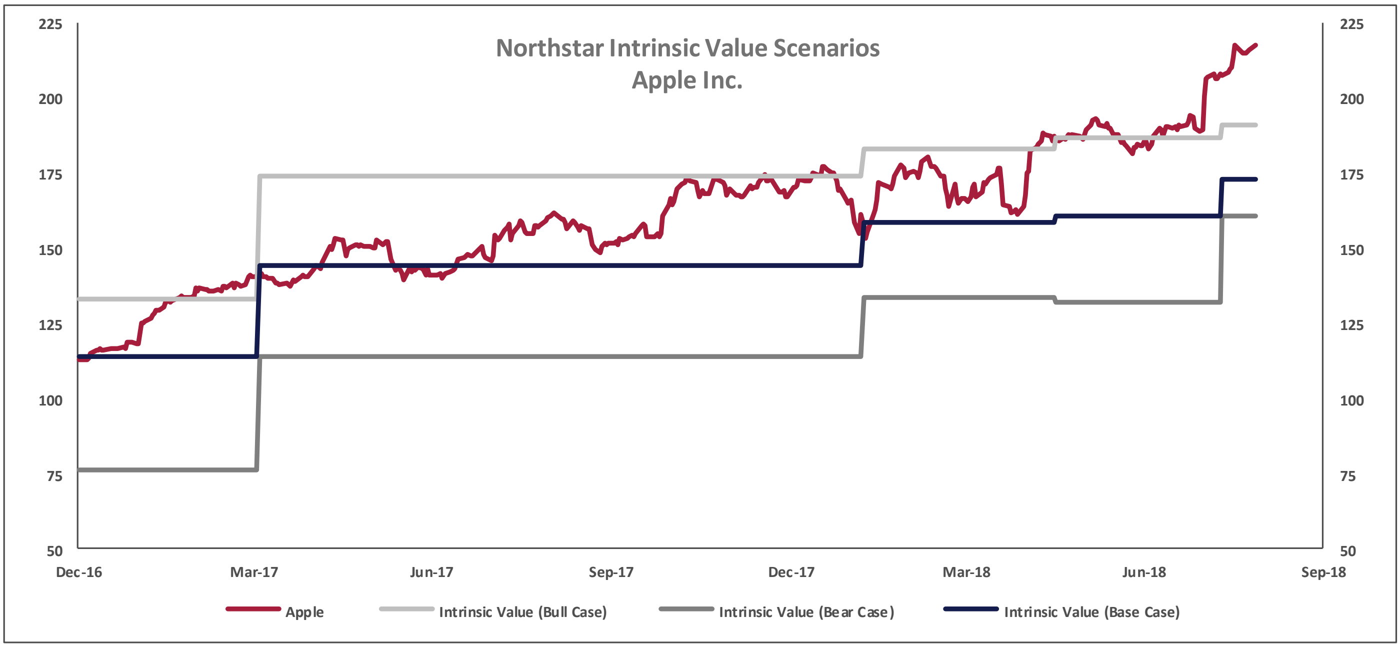

Figure 6. Apple Inc. Northstar Intrinsic Value Scenarios. Source: Northstar Asset Management.

The benefit of a probabilistic approach to valuation

It should be clear from the chart above, that while our intrinsic value estimates were revised higher over the course of the past year-and-a-half, the range of potential outcomes, i.e. the difference between the Bull and Bear Case scenarios, also narrowed.

This is a function of the greater conviction we were able to build in the investment case as well as the reduced forecast risk, which comes with more information and insight into the business.

Equally, by employing alternative scenarios we give recognition to the fact that valuation is never a precise exercise and new information and varied assumptions need to be assimilated and tested.

Developing these scenarios also ensures that clients' exposure to high quality businesses with strong underlying fundamentals is not cut short too early, whilst understanding and recognising the downside risk inherent in a Bear Case scenario.

[1] *Free Cash Flow – A useful measure to Identify Companies Worth Owning - Northstar Market Report Q3 2017.*

CORRIDOR CHATTER

IT'S MAY DAY FOR ELECTION 2019

By John Steenhuisen (Political Analyst)

The Zondo commission has finally got out of the starting blocks and already some interesting skeletons have begun to tumble out of the proverbial closet of State capture. Explosive testimony by former deputy finance minister, Mcebisi Jonas, has exposed the brazenness of the Gupta smash and grab on our economy. It remains to be seen if anybody will actually be held accountable but in true South African tradition, we hope for the best but expect the worse. As the Zondo commission unfolds, the slowing economy, petrol price increases and escalations in the cost of living have started to bite, citizens have begun to count the real cost of the scourge of state capture. Looking at state owned enterprises alone, R161 billion has been wasted on bailouts, subsidies and capital injections since 2008. Over at SARS, state capture has hollowed R140 billion in lost revenues. Together that is over R300 billion or 22% of the national revenue budget for 2017/18.

And of course all this takes place with the 2019 election moving swiftly towards us on the political horizon. This important election will take place in May next year and the run up to the poll will no doubt be woven with heightened invective and stirred-up emotions as key issues such as land reform, jobs and the economy, crime and corruption take centre stage. The political dynamic remains fluid with many different permutations for the future of the country in the mix.

As the outbreak of "Ramaphoria" of the last few months has been shudderingly brought to earth with the shrinking first quarter GDP results, growing unemployment figures and slowdowns in key areas of manufacturing, construction and agriculture; allied with the highly charged debate and public hearings on expropriation without compensation, the electoral prospects for the ruling ANC are not looking as fertile as they were in January. The ANC remains deeply divided in key provinces, most notably KwaZulu-Natal, where the spectre of the deposed and brooding Jacob Zuma still looms large. A low turnout for the ANC in their most vote-rich province will undoubtedly affect their share of the national vote. Smaller skirmishes in the Eastern Cape, Northwest and the Free State could have a similar effect.

Why is this important you may ask? Well Cyril Ramaphosa pegged his marketability at the ANC's Nasrec conference as the "not Zuma" candidate. Presenting himself as the magic elixir to resolve the ANC's flagging electoral fortunes that saw them lose control of three key metros in the local elections. If he is unable to match the 62.15 percent the ANC received in the last national elections under Zuma he could well find himself in some trouble internally within his own party. With the blood of a fair to middling election result in the water, the sharks, mainly represented by the ambitious Deputy President DD Mabuza, will undoubtedly start to circle, making it even harder for Ramaphosa to stamp his authority on an already fractious party, move decisively against the ANC rent seekers and implement the reforms he must know are needed to get South Africa back on track.

A dynamic that will also be interesting to watch is the evolution of the Economic Freedom Fighters (EFF) who appear to be moving ever closer to the ANC. This is demonstrated by their overt attempts to shield Deputy President DD Mabuza from parliamentary scrutiny and their v*olte face* in the opposition metro coalition arrangements. Julius Malema is an astute politician, he must by now have realised that his red overalls are not going to get him to the Union Buildings. An analysis of the trends of the last year of by-election results around the country in both rural and urban wards show that the EFF's votes have stagnated and in some cases declined. Clearly the radical and populist Chavez style policies, whilst able to fill halls and stadiums, have not found significant electoral traction amongst voters. At this stage it seems unlikely that the EFF will break past the 10% mark as South African voters embrace centrist parties and policies. It will be important to watch how the nexus, particularly between the EFF and the ANC faction around DD Mabuza, develops in the coming months.

It's also been a rocky-road for the main opposition party with the De Lille saga and some setbacks in the Metro's with fragile coalition government dynamics. It is essential for the party to get its message back on track and be in a position to capitalise on the weaknesses in the governing party and maximise opportunities opening up in the electoral landscape. More than ever before, it's going to be essential for a clear and compelling counter-offer to the citizens of South Africa to be made. The days of Zuma-bashing are gone and voters are demanding alternatives and policy solutions to the situation they find themselves in. It is essential for the opposition to retain the Western Cape, grow its vote share and also to make significant inroads in the key battleground state of Gauteng.

With little over 8 months to go until the election, lots could change, there is still some significant electoral road to travel. And as uncertainty and nervousness continues to rage over fundamental issues that face us as a nation; and as our democracy looks like a messy muddle, we are well reminded of what theologian Reinhold Niebuhr cautioned that: 'mans' capacity for justice makes democracy possible, but mans' inclination to injustice makes democracy necessary'.

ADVISORS' CORNER

NORTHSTAR ROADSHOWS 2019

By Adrian Clayton (Managing Director & CIO)

We are hosting advisors in Durban, Johannesburg and Cape Town on the dates and times indicated in the attached invite. This invite was e-mailed to all financial advisors which we have on record. Demand has exceeded our expectations in Cape Town and Durban but we are happy to accommodate more guests at all venues. Should you want to attend, please send an e-mail to info@northstar.co.za. You are also welcome to bring along your clients. Our existing Northstar clients will be hosted at similar events in the months ahead – please watch for invites in your mailbox.

NORTHSTAR **INVITATION**

WHAT FUTURE DOES SOUTH AFRICA HOLD FOR INVESTORS AND CITIZENS? ARE YOU READY FOR CHANGE?

WHAT NORTHSTAR IS DOING TO AVOID RISKS AND CAPITALISE ON OPPORTUNITIES IN THE NEW SOUTH AFRICA

PRESENTERS:

John Steenhuisen, MP

Adrian Clayton, CIO

Should you wish to bring a client or guest, please indicate this on your RSVP.

DATE	TIME	LOCATION
Tues, 23rd Oct 2018	12h00 - 14h00	DURBAN, The Oyster Box, Umhlanga
Tues, 30th Oct 2018	12h00 - 14h00	JOHANNESBURG, The African Pride Hotel, Melrose Arch
Mon, 5th Nov 2018	12h00 - 14h00	CAPE TOWN, The Vineyard Hotel, Newlands

Financial Planning Institute CPD points will be allocated for attendance.

Please specify any dietary requirements. Parking will be available.

Please RSVP before 10 October 2018

Click here to RSVP

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NORTHSTAR
ASSET MANAGEMENT

STAFF MEMBER PROFILE

ANDREW RANDLES

By Adrian Clayton (Managing Director & CIO)

What is your function at Northstar?

I am an equity analyst and work in the South African equities team. I am responsible for analysing various companies which are listed on the JSE. This involves writing up research reports on these businesses and building financial models on each. My reports play a critical role when our research committee decides whether our clients should be invested within a company or not. I am also a member of our research committee, which allows me to vote at the weekly research meetings. These meetings focus on companies to include or exclude from our Northstar Buy List.

When did your interest in financial markets start?

My interests in financial markets started late as I witnessed the sub-prime mortgage crisis and its contagion rip through world markets in 2008. I had been a student of economics before but the crisis and the prospect of micro and macro-economic evidence leaving a breadcrumb trail of a real market event, was intoxicating to me.

What did you study and why?

I studied law and economics, law because I have always had a knack for languages and economics due to an innate desire to know how the world truly works. I have also completed the Certified Financial Analyst (CFA) designation and have been a keen scholar of Chinese, I can speak a little mandarin.

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

I have an insatiable hunger for knowledge and desire to find the truth, this approach is well suited to being an equity analyst. My function is to unearth and package information for decision-making.

What do you love about investing?

It is the drive towards enlightenment and how information turned into knowledge allows for informed decision-making. Nothing beats the thrill of the market judging ones' decisions by the passing of time.

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

Being wrong! Companies are living entities that change and our investment thesis can prove incorrect as the direction of travel for a business deviates from what we imagined would occur. A common behavioural bias is to shift the investment case as a company's story shifts – it is critical to fight this and to learn from errors, they are inevitable.

Why do you think clients will do well at Northstar?

All my investable wealth resides in Northstar funds and so too most of my family's assets. I, as is the case with my colleagues, have a personal interest in the generation of long-term returns in our funds. We are totally aligned in this respect to our clients. Apart from that, we never stop thinking about generating returns – it keeps us alive in every respect!

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