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NorthStar: We know our top 50 buy list stocks better than 'our families'

The asset manager said its ESG process allowed it to avoid companies with poor governance, such as Steinhoff and Glencore.

BY**JUSTIN BROWN**

NorthStar Asset Management has 100 stocks on its buy list, including the top 50 counters it knows well.

'We have 100 companies on our buy list. Of those, 50 we know better than our families. Another 25, we know as well as our best friends. Then 25, we have a good understanding of them, but they're not family or best friends,' NorthStar chief investment officer Adrian Clayton told Citywire South Africa during an interview.

He said NorthStar and First Avenue Investment Management had formed a joint investment research venture. As a result, the combined buy list was likely to grow to 125.

'The integrity of the buy list will improve after the merger of the two teams and as we hire more analysts,' Clayton said.

'Most importantly, we do a bear, bull and base case valuation on every business. Then, we determine the probability weight discount the company trades at relative to what we think it should be trading.

'The discount we believe companies are trading at determines the entire asset allocation,' Clayton said.

During a Boutique Collective Investments webinar, he said NorthStar's first step in its equity selection process is screening.

'We screen over 1,000 offshore and JSE companies,' Clayton (pictured below) added.

NorthStar focuses on about 1,200 companies because those shares have a comprehensive set of data available to analyse.

'When a company does not have the data we require – they are not applicable,' Clayton said.

'There are 11 metrics that we screen for. Effectively they revolve around two important considerations: free cash flow and return on invested capital,' he added.

Research by a US investment firm found that two of the highest-rated criteria for generating long-term returns are free cash flow and return on invested capital.

'We want to see companies generate cash. We do not want to buy businesses that do not generate cash and wait forever for a return. Secondly, we like to buy into companies that have high returns on the capital and look after shareholders,' Clayton said.

After screening businesses, NorthStar has a 'shallow dive' process where they use proprietary methods to value companies to see if they are worth conducting fundamental research about them.

Four qualitative criteria

'For every company, we follow the same process. We try to understand the moat, management, and industry in which the business operates and do an ESG analysis.

'We score each one of those four qualitative criteria. A company must get past a certain score to get on our buy list,' Clayton said.

He said NorthStar looks for 'functional' industries.

'As a quality manager, we usually default to businesses with high intellectual capital. Typically med-tech, technology, pharma, and consumer staple businesses. We focus on quality at a reasonable price,' he added.

'We screen for quality and value and are trying to find high-quality companies that are underpriced,' Clayton said.

He added that NorthStar avoided cyclical businesses, particularly materials, utilities and oil companies.

'The return of invested capital of these businesses is awful. These industries suck in huge amounts of capital. Cyclical industries can be dysfunctional because there can be many players in them.

'For example, the iron ore industry can be a nightmare. However, it is getting better because of consolidation,' Clayton said.

Dominant players

Another example he cited is that when there are over three players in the telecommunications industry, the sector becomes dysfunctional.

'Another example is rail companies, which can be monopolies,' Clayton added.

'We don't mind many players in an industry as long as at least one or two dominant players earn high returns and have pricing power at the expense of many smaller players,' he added.

NorthStar tries to avoid industries with dysfunctional pricing. Clayton said the steel industry was an example of a sector that experienced dysfunctional pricing due to 'hyper competition', subsidies by the government and dumping of cheap products.

'The same thing applies in the sugar, cement and fertiliser industries,' he added.

'We like to find companies with a competitive advantage that can beat their competition. We look for strong management teams focussing on shareholder returns and not looking after their own pockets,' Clayton said.

He said when analysing management teams, NorthStar looked at a company's remuneration committee and how often the board members change.

‘ESG plays a big role, and that goes back to our history of [hardly] owning [any] Steinhoff [shares], for example, and various other businesses where there were big governance issues,’ Clayton said.

Governance issues

Another company that Northstar has avoided due to governance issues is Glencore.

Clayton said NorthStar tried to understand the source of a company’s moat and its durability when assessing its competitive advantage.

‘Microsoft is a great example. Its operating system has been dominant for five decades or longer,’ he added.

NorthStar has over R6bn in AUM and four strategies.