NORTHSTAR
ASSET MANAGEMENT

Client Letter 23 July 2015

Quarter End: 30th June 2015

Dear Client,

It is our privilege to again be communicating with you with regards to our thoughts on markets and most importantly, our research developments within Northstar. We have dedicated this Northstar Market Report to offshore investing, a topic of interest amongst our clients at present.

For us at Northstar, investing globally is no different to anything that we do at home. We reduce complexity by screening companies on measures of Quality and Value and for those that rank highest, we undertake detailed research. We cover two offshore stocks in our report, namely Heineken and Markel, as we believe that these stories will resonate with you. In typical Northstar fashion, the investment thesis on both companies is a multi-year time horizon and we seek companies which will outlive all of us.

You will notice that we have not embraced the spiny subject of South African politics as a key reason to invest abroad as we claim little deep-seated knowledge in this regard and it is certainly not where we focus precious research time daily. However, this too is a topic of interest amongst Northstar clients and, consequently, we have decided to introduce external 'expert' views on matters outside our core competency set, allowing our clients to form their own opinion. As a start, we have purchased for you a copy of RW Johnson's book, *'How Long Will South Africa Survive? The Looming Crisis'* and hope that you find this of interest. We would like to point out that we do not necessarily share Mr. Johnson's views and we intend sourcing the writings of other authors that may well contradict his perspective.

We are avid readers at Northstar and encounter many great pieces of literature covering many subjects, with the primary focus being investing. Consequently, we have decided to send our clients our best read of the year as an annual gift.

We look forward to keeping our heads down and finding wealth generating opportunities for you in the quarter ahead.

Kind regards,

Adrian Clayton
and the Northstar Team

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Offshore investing remains a long-term attractive option:

Our June 2015 Northstar Market Report focuses on offshore investing as we delve into the investment cases of two of the many companies that have attracted our attention over the past two years.

This report purposefully does not address the socio-political reasons for allocating capital away from South Africa nor have we brought the rand into this discussion. It is our contention that investing globally makes sense on a multi-decade view for reasons transcending currency speculation and guessing about political outcomes. We must point out that we do not believe offshore investing should be seen as a definitive alternative to local investments. The JSE has many great companies which we deem as core long-term holdings and we believe that domestic and foreign investments should coexist.

Two key points justify investors having a global perspective with regards to their capital. The first being that the breadth and depth of investment options is so much greater abroad than in South Africa and the second is that currently, the majority of South African shares are not as well priced as certain global alternatives. Fortunately, this second point can change quickly.

Depth and breadth of offshore offering dwarfs that of the JSE:

We have access to financial data of 60 000 global companies. While we are clearly not in a position to analyze all of them, the point is that the global opportunity set is vast and applying logical screening systems has allowed us to identify high-impact companies to analyze. The domestic market has approximately 450 listed companies and 169 companies constitute the JSE FTSE All Share Index. Comparing this to the New York Stock Exchange (NYSE), one of three stock markets in the USA, it has 2000 listed companies, 400 of which are foreign listings. Two other stock markets operate in America - the NASDAQ, with 3200 listed companies and AMEX, which is full of exciting small and medium sized companies. The JSE is the 17th largest market by capitalization at $0.85 trillion, yet it represents less than 3.5% of the size of the NYSE, with a market cap of $25 trillion.

The JSE is not as well priced as other markets:

There are few quality companies on the domestic market that trade at reasonable prices relative to their long-term fair valuation levels. The cheapest parts of the JSE are commodity companies, but these businesses are facing their own demons with a tough macro-economic backdrop suppressing commodity prices.

Even relative to emerging markets, which are actually our best comparison, our market is not cheap. The JSE's price-to-book ratio (a measure of valuation; the higher the ratio, the more expensive the market) is 2.8 times, compared to the average for emerging markets of 1.6 times. Granted, the JSE's return on equity has been higher than other markets, which has led to it being more highly rated. That said, our 2015 P/E is 16.4 times against an average of 12 for other emerging markets. Unfortunately, our market is expected to deliver lower earnings growth relative to other emerging markets in the year ahead, resulting in us being the 5th lowest profit generator.

The brevity of this report prevents us from expanding on the topic of the relative valuation of SA stocks versus global peers. Suffice to say that, as we at Northstar screen for quality companies that trade at reasonable prices, at this stage we are finding more of these offshore than domestically.

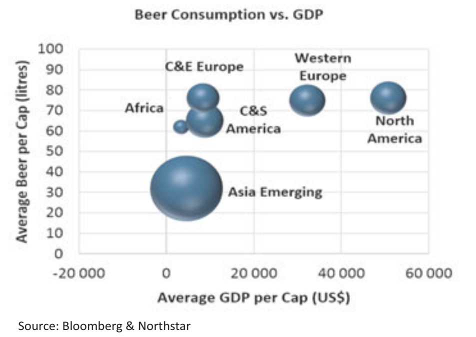
How we assess an investment opportunity:

Our clients are acutely aware that our analysis focuses on four areas of research which we believe provides clarity as to whether it is worth allocating capital to a specific company. To recap, these four areas are: the competitive landscape the company faces, its strength within this landscape, the success that management have shown in steering the business and our view of what the company is worth versus how it is being priced by the market. Our goal is to buy well managed, quality companies which are being priced by the market at levels that are less than what we believe the company to be worth. On that note, we describe below how Heineken and Markel stack-up on these measures. We conclude our analysis of each company by comparing its price performance to the closest proxy stock in South Africa. Heineken is compared to SABMiller and Markel to Santam.

Heineken – stability and growth at a price discount to SAB:

We were drawn to Heineken in September 2013.

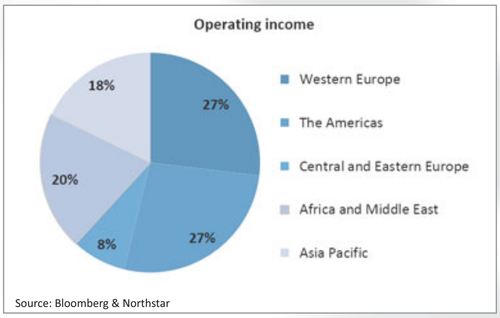
With regards to the competitive landscape, massive brewing consolidation has been a key trend in the global industry over the last decade. In 2003, Anheuser-Busch was the world's largest brewer owning 8.3% of the global market, but in 2008 it merged with InBev, creating a mega brewer with 21% market share. Various other deals including Heineken's $24bn acquisition of Asia Pacific Breweries (APB) completed in 2012 further consolidated the industry. In 2003, the top five global brewers controlled 32% of the world's beer market and by 2013, this had risen to over 50%. Industry concentration tends to be very positive in that large dominant players usually avoid price wars and giants have more control of their costs by forcing supplier input costs down. In addition, clients or customers have limited bargaining power with bigger firms. The brewing industry is one that looks attractive from an industry perspective.



Source: Bloomberg & Northstar

Heineken's competitive position within its industry is also favourable. It boasts a distribution network of 125 breweries in 70 countries, over 200 brands and one of the only truly iconic global beer brands – the famous green bottle. What is particularly attractive about Heineken is that, although it is exposed to markets that are under some pressure – most notable Eastern and Western Europe, it is equally exposed to fast growing markets in Asia, the Americas and Africa. In many of its markets, it is the market leader. The graph above reveals the importance of having exposure to emerging markets – it shows that as economies develop, consumers have increased wealth and beer consumption rises. The size of the bubbles represents the size of the populations within the countries concerned. Africa is constituted by three countries.

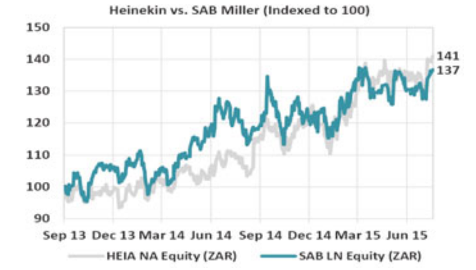
The Heineken Management team has shown a deftness to navigate reducing volumes in Eastern Europe as recessionary conditions have depressed beer consumption. They have also managed their exposure to mature beer markets in Western Europe very well. Sustained Group profitability has been achieved by adjusting their product mix to higher profit margin products and by actively reducing costs within the business. Proof of this is that between 2012 and 2014, Heineken Management eliminated over 500m euros of costs within the business – this played a large role in lifting operating margins from 12.4% in 2008 to 16.2% in 2014.



Source: Bloomberg & Northstar

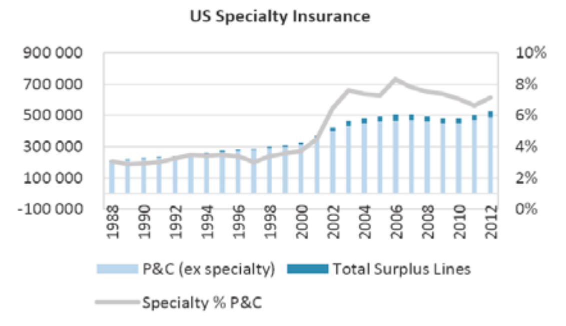
Managing Heineken has involved a two-tiered approach - the first is to manage low and no-growth markets, the second is to continue to pursue and invest in high-growth markets. This dual attack has worked well and the acquisitions of FEMSA in the Americas and APB in Asia are testament to this. In so doing, the management team has created a highly diversified and well balanced global brewing portfolio as depicted in the graph on the left.

Valuation – when we first looked at Heineken, it was trading at what we deemed to be fair value, although, without a significant margin of safety. However, the company's consistent earnings profile, its sound management team, global portfolio and underappreciated investments in fast-growing markets led us to feel comfortable with owning the business. We also noted at the time that SABMiller enjoyed a significant premium rating to Heineken and, although we believed the market was justified in rating SAB above Heineken until 2014, it was our view that the extent of the premium was overdone. The graph on the right shows how Heineken's share price has appreciated since September 2013 and has started to outperform that of SABMiller.



Source: Bloomberg & Northstar

Markel – an exceptionally well managed business benefiting from an improving US economy:

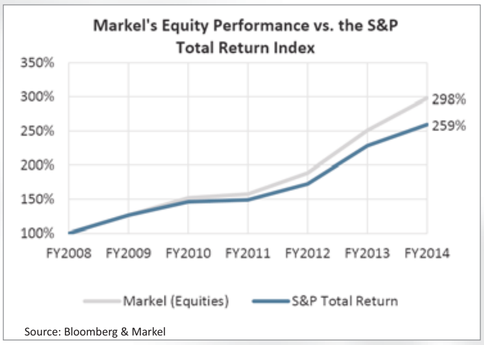


Source: Markel & Northstar

Our research on Markel occurred in July 2014. Markel is a financial holding company but its primary business is the marketing and underwriting of specialist insurance products.

It is the 8th largest specialist insurance underwriter in the USA, underwriting and insuring in niche markets such as wind and earthquake-exposed buildings, workers compensation in small firms and classic cars. This is an incredibly technical industry requiring specialist skills built up over decades. It is also an industry that has enjoyed phenomenal growth over two decades, as shown by our graph on the right.

Although insurance and underwriting is a competitive and cyclical industry, most insurers focus on general insurance, which is highly regulated and particularly so when it comes to pricing. Markel on the other hand, focuses on specialist areas, offering higher profit margins due to unregulated pricing. Within the specialist space there is a high degree of industry consolidation. As an example, in 'surplus lines', which is custom made insurance, the top 15 firms control 63% of the market – between 2001 and 2011, the number of specialty insurers in the US declined by 50% to 60 companies. In our view, Markel has positioned itself within a niche space in insurance with more favourable market dynamics.



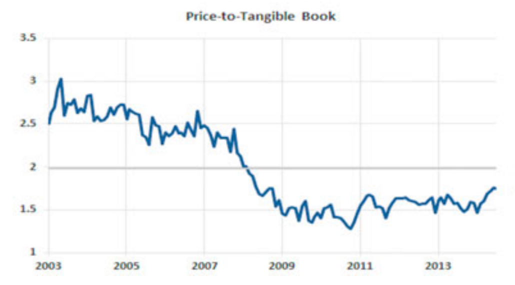
Source: Bloomberg & Markel

At the time of researching Markel, it struck us that the specialist insurance industry tends to track GDP growth and labour markets closely. As the US economy was expected to brighten up, we felt that tail winds would be blowing for Markel, which has proven to be the case.

Markel's own competitive position within the industry is also favourable – as mentioned above, it enjoys a 3% market share in an ever-consolidating industry. Proof of this is Markel's acquisition of Alterra Capital Holdings, another underwriter, in 2013. This transaction increased Markel's insurance book, its breadth of clients and gave it an even larger distribution force of sales agents, diversifying it away from dominant broker groups that control an unhealthy percent of premium flow to underwriters.

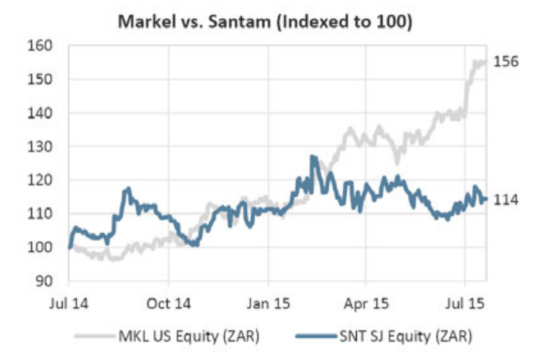
Another attraction of Markel is its private equity arm known as Markel Business Ventures, as well as the exceptional track record which the management team has developed in managing Markel's own investment portfolio. The management of the investments within this business has been exemplary - the compound annualized growth rate (CAGR) of the Markel equity portfolio over 10 years has been 13.4% versus the S&P which has grown at 7.4%. We show this success in the graph above. As far as fixed income management is concerned, here too the Markel portfolio managers have performed very well, producing returns of 4.8% annualized versus the JP Morgan Aggregate Global Bond Index of 4.2%.

From a valuation perspective, Markel was certainly not expensive at the time of our analysis. The investment thesis can be summarized as an opportunity to acquire a great business trading at a discount to its long-term Price-to-Book ratio of two times, with an outstanding management team and positioned within a growing industry. The graph on the right shows the Price-to-Book of Markel over time and the discount at which it was trading last year when we started investing in the company.



Source: Bloomberg & Northstar

We appreciate that Santam is not directly comparable to Markel, however, as South Africa's best quality underwriter, we are using it as the most appropriate domestic proxy in this analysis. The graph on the right shows the outperformance of Markel over Santam since we undertook the research. Even in their home base currencies (Markel in dollars) and (Santam in rands), Markel has been the winner over the past year, returning 34%, versus 14% for Santam.



Source: Bloomberg & Northstar

In conclusion, we are finding more investment opportunities abroad than we are in South Africa - a function of elevated domestic stock prices but also a significantly larger opportunity set globally. Northstar has built up a deep research DNA over many years and we are well equipped to capitalize on offshore as well as domestic opportunities for our clients as and when they arise.

Adrian Clayton and the Northstar Team