NORTHSTAR
ASSET MANAGEMENT
Market Report

Northstar Market Report – March 2016

The past quarter – gloom, doom and then boom!

South Africans – so quick to play Chicken Little:

We noted with interest how gloomy retail and institutional investor sentiment had become during the latter months of 2015 and early 2016. As is normally the case, and we touched on this in our last Quarterly Report (The South African Rand – Where to from here?), South Africans are quick to adopt the 'Chicken Little' syndrome and similar to dim-witted Chicken Little, whip the farmyard into mass hysteria only to be manipulated and ultimately consumed by the unscrupulous fox – analogous to those that do not panic and instead profit off irrational market psychology.

Resources bore the brunt of the negativity:

In every respect the Chicken Little story has played out over the last year, particularly in the past quarter. Markets were horrific late 2015; domestic factors culminating in Nenegate added fuel to a poor global backdrop for markets. The JSE fell by 3% in January, this followed on from falls of about 4% in November and 2% in December. The punishment was most severe for resource shares, bar for two months, the resource index collapsed monthly from April last year and in November, it crumbled 21%. December and January were brutal months too.

But as the story goes, the sky never actually falls and March was a great month for markets, following on from February, where the All Share Index rose 0.6%. The Rand has strengthened 15% from its worst levels of R16.84 to the dollar which it reached on the 18th of January 2016. The local bond market has rallied 6.6% since January 1st, after having produced a return of -3.9% in 2015 and resource shares have surged 15.6% in February and 5% in March.

Considering the about turn in sentiment, the obvious question on investors' minds currently is whether the latest re-rating in asset values (stocks, commodities, emerging market currencies and bonds) are green shoots leading to a sustained emerging market re-rating in the months and years ahead, or a short-term rally within an unfolding bear market?

The dark side of the moon – a slowing world economy:

Markets often lead economies into and out of gloom:

Markets often lead economic data and with commodities, emerging currencies and secular assets re-pricing upwards, it may well be that economic data turns sustainably higher. Market participants often talk about Mr. Copper, as copper has an uncanny knack of predicting prospective GDP growth. As is evidenced by the attached graph, the copper price has surged over the past two months and this could well imply a turning global growth outcome.

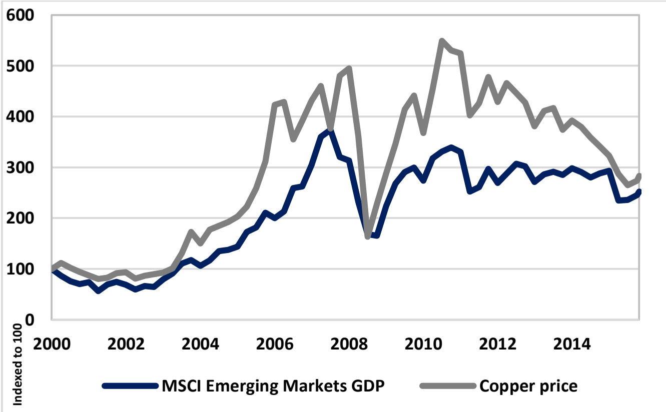

Figure 1. Emerging market GDP vs. the Copper price source: Bloomberg

But before we get ahead of ourselves, the cold facts of current negative economic reports demonstrates rather lucidly that betting the house on risky assets will have a very wide distribution of outcomes, some of which could prove unpleasant. Added to this, commodity cycles do not happen that often and in fact, even the most bullish of commodity commentators such as Jim Rogers validates this view. 'Historically, there has been a bull market in commodities every 20 to 30 years.' - Jim Rogers.

Economic data points to a struggling world:

Emerging Market Purchasing Managers Indices (these are indices which read economic health) continue to fall as GDP forecasts are being pared back by strategists for emerging markets – much the same is happening with regards to advanced economies too. Russia and Brazil are in severe recessions and China's growth is expected to decelerate each year into 2017. India is the present ray of hope in the BRIC consortium; its economic growth is buoyant and rising. In the attached graph we show the extent to which economic data is weak for emerging markets.

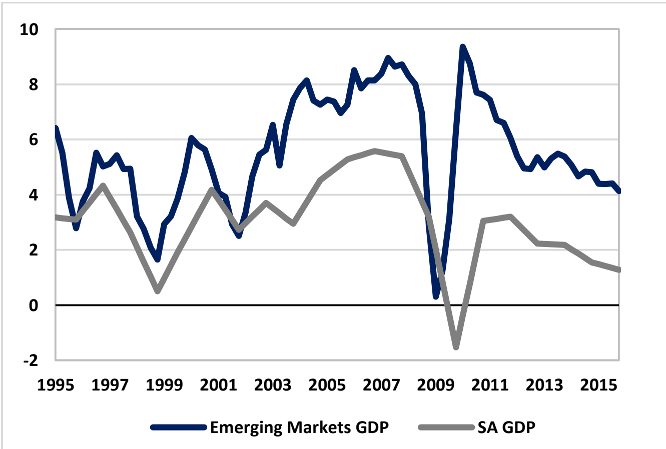

Figure 2. Emerging Market & South African GDP YoY% source: Bloomberg

Debt levels are high in the emerging world whilst GDP growth is falling:

As economies wallow, budget deficits have been rising and fiscal pressures are escalating for many of the commodity led exporters at a time when monetary restraint is required – South Africa being a prime example. Emerging market capital outflows from institutional and retail investors which began in earnest in 2014, have continued well into 2016, albeit that these have reversed over the last four weeks. This stew of low growth, weak currencies, high debt levels and imported inflation has made the management of these economies extremely complex. Central banks have been forced to adjust interest rates higher at precisely the time when ailing economies least need it.

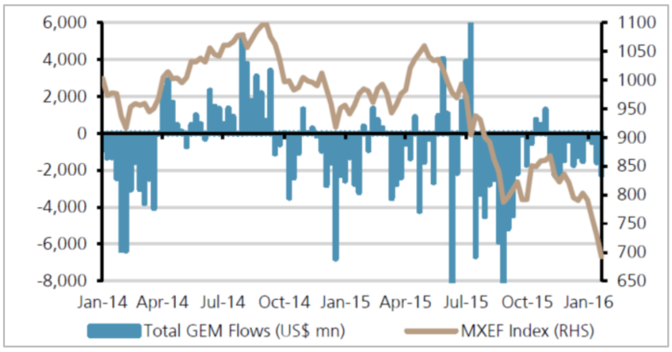

Figure 3. Emerging market capital flows & MSCI Emerging Market Index source: EPFR Global, UBS, Bloomberg

Captain America back to the rescue – The Fed intervenes:

Against this backdrop and ironically due to it, the Fed has tempered its monetary path for tightening, pausing dollar strength and creating an improved feedback loop back to riskier assets; emerging markets being the prime recipients of investor confidence. It is thus unsurprising that the 'riskiest' of investment destinations have enjoyed the greatest rebounds in confidence over the last six weeks – Brazil, Turkey, SA and Poland – all of which are also facing sovereign rating downgrades.

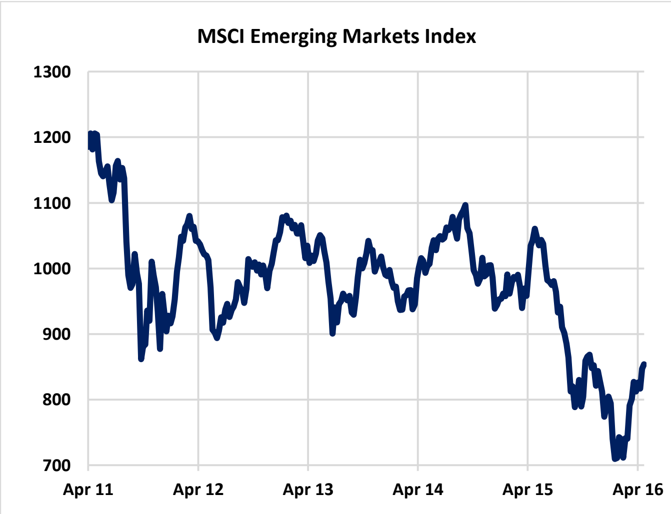

Figure 4. MSCI EM Equity Index - a tough 5 years source: Bloomberg

Certain Asian economies have inherent strength:

Emerging markets should however not be perceived as a homogenous group, emerging Asia has various bright spots and although global growth is currently muted, monetary accommodation is expected to sustain asset valuations for the time being and any prospective improvement in global growth will be leveraged through those markets as asset prices are generally cheap.

The South African economy remains in a bad place:

Quite the opposite of well-run Asia, are the dynamics locally. South Africa has a hideous economic backdrop yet many asset prices are not reflecting this. We think binary risk is high. Stagflationary pulses are present as domestic growth falters and inflation surprises to the upside. Headline inflation (CPI) could peak at about 7.5% while core is expected to edge close to 6.5%. Against this, GDP growth will not reach 1% and might only sneak above 0.5% in 2016. A stronger Rand will assist to reduce imported inflation, but could upset industries finding export markets to circumvent tepid domestic demand.

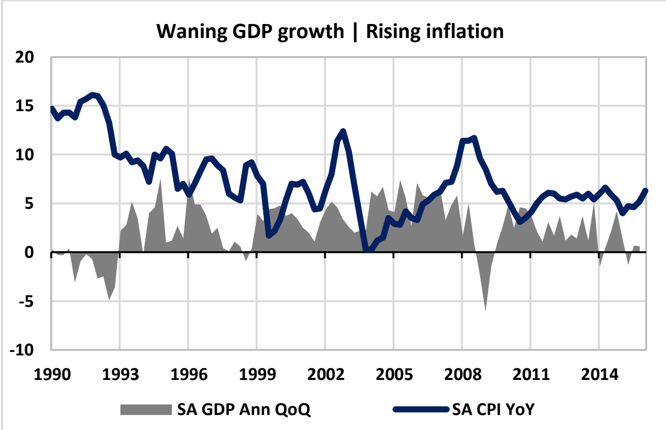

Figure 5. Waning GDP growth and rising inflation source: Bloomberg

South African stocks – a mixed bag:

Considering the domestic economic environment is so poor, does this imply that the JSE is to be avoided as an investment destination? The answer is definitely not! Although our market is full of contradiction with certain sectors and stocks looking outrageously expensive, there are still valuable and rewarding opportunities present. What follows is a short synopsis of our thoughts in this regard.

Domestic consumer stocks are expensive:

On the domestic front, a number of the cyclical consumer stocks (retailers, transportation stocks) have been re-priced higher in 2016 on expectations that rosier times are ahead in SA. We are sceptical and our work shows clearly that many companies relying on the domestic economy have stretched valuations. We believe that profits for these companies might well not meet the market's expectations and consequently, we believe that patience will be rewarded in being able to buy these businesses at compressed valuations in the years ahead.

Figure 6. General Retailers PE Ratio - Expensive levels source: Bloomberg

Many commodity stocks have surged ahead of fundamentals:

Although many commodity companies were oversold in 2015, it is our contention that some of these companies have rallied hard on the latest surge in market confidence precipitated by the Fed which has orchestrated dollar weakness rather than due to underlying fundamentals of supply and demand in their respective markets. Consequently, we do not view this commodity rally across all the commodity companies as sustainable and various stocks are now trading above what they are actually worth. To change this view, commodity prices will need to rally further and 'catch up' to the share prices of the companies which produce them. We need evidence that real demand for these commodities is in place on a consistent basis and presently, we fail to see China or any other player creating smooth demand as was the case from 2003 to 2008 and again from 2009 onwards. Of particular concern is the iron ore market!

South African banks are cheap:

We believe that many locally listed financials stocks are cheap, particularly SA banks. Dividend yields are high and at current levels subsidize share ownership (dividend yields currently exceed 6% in the sector). We appreciate that banks are usually at the epicentre of any global economic dislocation and if the World's economic system does not heal itself by reducing debt levels, then fertile ground is being created for a financial crisis. Historically, financial crises have stemmed from periods of prolonged debt creation, similar to what has occurred since 2008. So whilst we believe our clients should own sizeable positions in SA banks - based on their reasonable pricing and high dividend yields - we must confess to expecting a rocky road ahead.

Figure 7. SA Banks PE Ratio- Reasonable levels source: Bloomberg

Small and mid-caps – many unloved stocks offer value:

In our market we are finding that various mid and smaller capitalization companies are falling off the radar of investors and consequently, these stocks are cheap. Of these companies, a certain number, derive their income by being suppliers to mining giants as opposed to being directly exposed to consumers. It follows that the repercussions of a tough commodity cycle, particularly in that they follow a 'derived demand' business model, has meant that their financial results have been poor. We note with interest though, that the best of these businesses have survived the peaks and troughs of many mining cycles during the last century and are extremely well managed and resilient companies. As is typical of markets though, the good have been thrown in with the bad and even high quality companies' share prices have fallen by more than their financial results. We are finding value in these businesses.

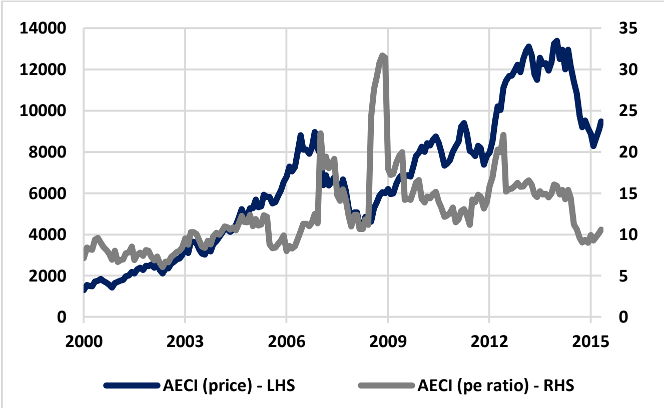

Figure 8. AECI - Prices vs. PE Ratio source: Bloomberg

Great offshore companies remain a core ingredient to generating sustainable wealth:

Other than our constant search for quality companies domestically, we remain of the view that our foreign stocks offer value, are of very high quality and are consequently sound long-term investments. We are widely positioned across markets, from Asia to Europe and the USA; a larger playground has allowed us to express our process and philosophy constructively. On this note, in this report, we will be discussing one of our preferred offshore companies, Union Pacific.

Union Pacific – Building America - Anchored by quality with predictable outcomes:

Considering the market's exuberance over the past six weeks with companies that have weak moats (competitive advantages) and which rank as lower quality in our ranking model, we decided to write on a polar opposite business, one which boasts a deep moat and thus massive competitive advantage within its industry – Union Pacific, the US railroad business.

Union Pacific – Building America:

Union Pacific (UNP) is a dominant player in the US logistics landscape and one of only seven class 1 railroad operators in the United States. Its network is extensive in that it links 23 states in the western two-thirds of the US and acts as a critical link in that country's supply chain.

The investment case:

Union Pacific ticks many of our boxes when it comes to the analysis of the industry the company operates in, the company's moat or competitive positioning, the company's management and the valuation the company is trading at.

The industry:

Industry deregulation (the 1980 Staggers Rail Act in favour of railroad operators replaced the regulatory structure that existed since 1887 which specifically curtailed rail pricing) and consolidation over three decades has allowed the larger railroad operators to grow their volumes, increase their prices and gain market share over other forms of transport such as trucks.

There are only seven Class 1 US railroad giants, they account for 69% of US freight rail mileage, which is approximately 96000 miles of track, they operate across 44 states and transport high volume, long-haul intercity traffic. It is thus a highly consolidated industry – this prevents dysfunctional industry behaviour or dynamics. We show in the attached graph (Number of Class 1 railroads and miles of road operated) the extent to which the industry has consolidated since 1980.

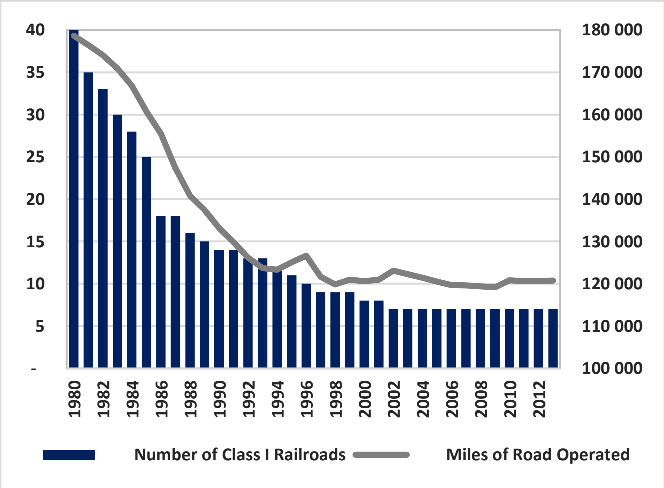

Figure 9. Number of Class 1 railroads & miles of roads operated source: Northstar

The key ingredient to the industry which ensures that competition remains limited, is that as soon as rail infrastructure is in place for an operator, there is limited economic benefit for multiple competing players to service the same routes. The main competitor to Union Pacific is Burlington Northern Santa Fe (BNSF) which is wholly owned by Berkshire Hathaway.

The other noteworthy feature of rail transportation, particularly for long haul operators is that they can under-price trucks, trucks being their main source of competition over long distances.

The moat:

Union Pacific has a highly diversified intermodal business mix, it transports agricultural goods, automotive parts, chemicals, coal and industrial products. Its network of rail is extensive, linking Chicago in the east, to the Gulf of Mexico in the south, to all major ports along the Pacific west coast and then right up to Seattle in the north. Only BNSF rivals this network.

To appreciate the dominance of these players one needs to only look at their ability to pass pricing onto their clients. In the attached graph (Revenue Composition), we show the performance of the intermodal division and how Union Pacific prices have been lifted each year (dark blue) except in 2009.

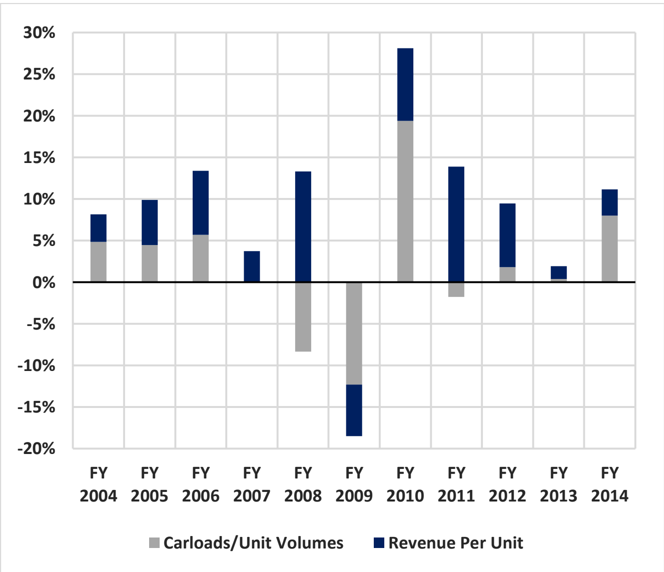

Figure 10. Union Pacific - Strong pricing power source: Northstar

Management have also actively entrenched the company's moat, as can be seen in the extent to which UNP has been investing (capital expenditure), yet free cash flow has consistently risen since 2000.

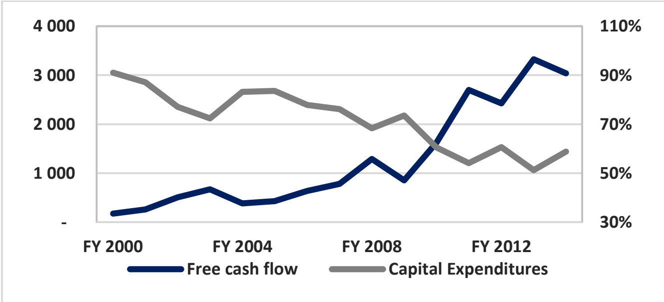

Figure 11. Union Pacific: Free Cash Flow vs. Capital Expenditures source: Northstar

Management:

We assess management teams of companies based on their capital allocation decisions. Management can allocate capital by investing in the current business, paying dividends, making acquisitions, buying back shares or increasing or reducing debt. These decisions, if performed properly, lead to sound investment returns for stakeholders over time.

In our view, the management team at Union Pacific have been great custodians of shareholder wealth. They have played a meaningful role in lifting the return on capital in the business from 3.2% in 2004 to mid-teen levels at which it currently operates. It encourages us that the top team at Union Pacific have steered the group for decades with Jack Koraleski (executive chairman) having joined in 1972.

In the graph below, we show the improvement that Union Pacific has seen in return on equity since 2004 and much of this we ascribe to solid managerial decisions.

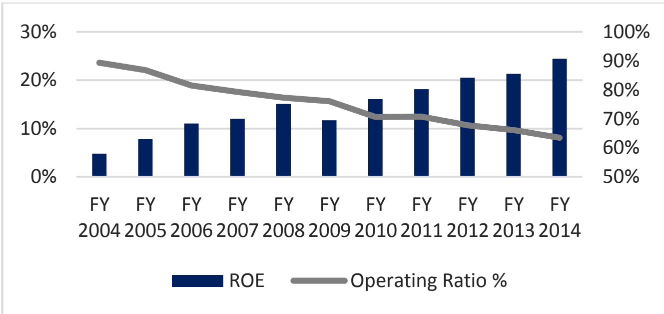

Figure 12. Union Pacific: Return on Equity vs. Operating Ratio

Valuation:

From what we have discussed above, it should be clear that Union Pacific ranks highly on our fundamental research scoring process which focuses intimately on the industry, moat, and management of a company. The final hurdle for any company is the valuation work – this is where the rubber hits the road and is all about getting to grips with what the business is really worth?

Even great companies are not worth owning when they are very expensive. This is not the case for Union Pacific and by our calculations, the stock continues to offer upside, albeit not a dripping roast after a healthy rise in share price over the last two months.

Considering the possibility that commodity prices might collapse again and UNP generates a fair deal of its revenue from transporting coal and gas, there might well be some pressure on the earnings of the group in the year ahead. This could also coincide with a weak share price.

As Buffett so rightly put it, 'it's far better to buy a wonderful company at a fair price than a fair company at a wonderful price'. Any weakness in the share price of Union Pacific will offer long-term investors a chance to purchase a wonderful company at a very fair price!