NORTHSTAR
ASSET MANAGEMENT

Client Letter 10 October 2014

Quarter End: 30th September 2014

Dear Client,

It is with a sense of composure that we write our September Northstar Quarterly Market Report.

2014 has been a year of market gyrations - in January we saw steep share price falls (-3%), the bourses subsequently recovered, grinding repetitively higher and gaining 15% to the end of July. From its peak, to the end of September, the JSE has retreated approximately 6%. Throughout these highs and lows, the Northstar Research Team has ignored the noise and remained firmly on track with our focused task of unearthing the best quality companies that offer the best value for our clients.

Over the past year, our portfolios have outperformed the market which we ascribe to owning businesses that have strong balance sheets, excellent management teams and are fiercely competitive within their respective industries. The strategy of holding companies with these qualities remains entrenched at Northstar, particularly in a world showing signs of retreating into an economic morass.

In addition to our continued steady application of research, we also worked hard this year at launching the Northstar Met Income Fund. This new Northstar fund is designed to house our clients' monies in a safe and secure environment aimed at outperforming low-yielding bank accounts over time. The Northstar Met Income Fund completes our minimalistic but powerful domestic product suite – we offer an income, a balanced and an equity solution – appropriate considering varying client risk and return needs. In each of these product categories, the Northstar Team has many years of investment experience and world class track records.

Our Quarterly Market Report covers two topics. The first addresses the question, 'By how much does the JSE need to fall before stocks offer real value again?' and the second answers the question we were asked by many of our clients this year - 'Why did we not buy African Bank for Northstar portfolios?'

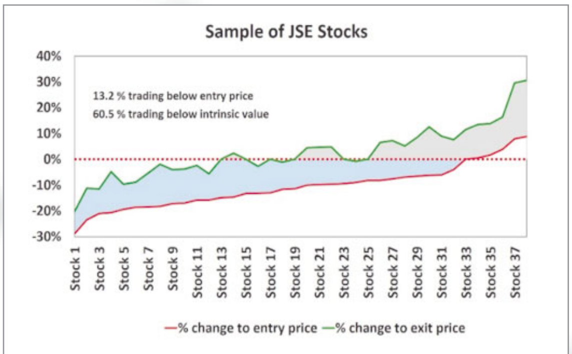
We look forward to communicating with you in the months ahead on developments in the markets and our ongoing drive to find the best valued investment opportunities for your portfolio.

Adrian Clayton
and the entire Northstar Team

NORTHSTAR ASSET MANAGEMENT (PTY) LTD.
TIME | VALUE | QUALITY
Tel: 021- 810 8400 Fax: 021- 794 2885
email: admin@northstar.co.za web address: www.northstar.co.za
Suite 1A Madison Place Alphen Office Park Constantia Road Constantia South Africa
PostNet Suite # 784 Private Bag X16 Constantia 7848 Directors: AJ Clayton, TJ Otten, MK Seymour
Company registration number 1996/001423/07 VAT registration number 429 01 666 46
Member of the Fund Managers Association of South Africa Member of the Investment Analysts Society of South Africa
Regulated by the Financial Services Board of South Africa Authorised Financial Services Provider - License number: 601

Establishing fair value for SA listed companies:

Our consistent message in 2014 has been to err on the side of caution. It is true that no other asset class can match equity returns over time, but it is equally true that equities can become expensive and astute investors understand that market excesses are unsustainable.



Source: Bloomberg & Northstar Asset Management

As we have written previously, timing markets is impossible and expensive markets can become increasingly expensive for years and, consequently, exiting markets altogether can destroy wealth rather than create it. That said, 2014 has been a year when an expensive market, the JSE, has become increasingly expensive. A question we are consistently asked by clients is, 'How much do stocks need to fall before the JSE is reasonably priced?'

Our analysis of companies focuses on valuing them and assessing this value versus how the market is pricing these businesses. The graph adjacent depicts the degree to which various company share prices need to fall before they reach valuation levels which, in our view, are fair.

Stock 1 above requires its share price to fall 20% (difference between the dotted red line and the solid green line) before it reaches what we believe to be the company's true value. Northstar does, however, like to include an additional 'margin of safety' before we commit capital to an investment. In order to gain this extra buffer, Stock 1's share price would need to fall another 10% - to the dark red line. Performing this exercise for a grouping of companies reveals that most stocks require price reductions in excess of 10% to be fairly priced. Some of this excess has already been removed from stocks with the correction in the market which has taken the JSE back to levels last seen in February 2014. We do, however, feel that there are many stocks in our market that remain overpriced and our goal is to avoid these for our clients.

Why we avoided buying African Bank?

A number of clients contacted us this year to enquire as to whether it was not an opportune moment to purchase African Bank shares, noting the collapsing share price and how 'cheap' the company had become. In this article, we provide a brief explanation as to why we decided to avoid deploying capital into this business on behalf of clients.

1. The consumer credit landscape in South Africa:

Our starting point was the ever-worrying trends in the consumer credit landscape in South Africa - we cite the South African National Credit Regulator statistics:

- From Dec 2007 to June 2014, the number of credit active consumers in South Africa increased from 16.8m to 22.1m – 5.3m or 32% more consumers entered the credit market.

- From Dec 2007 to June 2014, the number of consumers with impaired records (deterioration in the credit worthiness of consumers) increased from 6.1m to 9.95m – 3.9m or 63% more consumers found their ability to repay loans diminishing.

- The credit standing of consumers as at June 2014 looked generally dismal as follows:

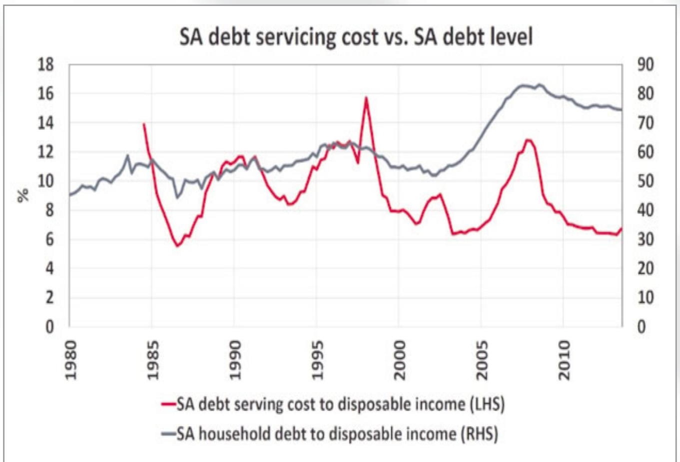
- 42.2% were up to date with payments.
- 12.8% were 1 to 2 months in arrears.
- 28.3% were in arrears for 3 months or more.
- 5.2% had adverse listings against them.
- 11.4% had judgments and administrative orders against them.

Our rather simple observation formulated from these and many other statistics, is that the quality of the credit market deteriorated at a rate faster than the growth of the market – this added risk for the financiers of credit.

2. SA household debt to disposable income and debt service costs:

In the short-term, a debtor's propensity to repay a loan is less a function of their quantum of debt and more about their ability to service that debt. This is something central banks around the world have been acutely aware of and is precisely why they cut borrowing costs rapidly post 2008, lowering debt service costs for the over-indebted. SA household debt relative to disposable income (see graph below) took a step higher in 2002. Having traditionally been at manageable levels of below 60%, this reached 82.3% in 2008. Fortunately, the South African Reserve Bank (SARB) responded in unison with other central banks and cut the cost of debt finance – the prime rate reduced from 15.5% (2008) to 9% (2012). This allowed households to reduce the allocation of their monthly budgets aimed at repaying debt from 12.8% in 2008 to 6.7% in 2012.

Whilst debt service costs are low, household debt, in total, relative to disposable income, remains high in South Africa at 74.5%. As clients are aware, we have been of the view that interest rates are too low in our country and, although we are probably experiencing a muted interest rate hiking cycle, even a 2% change in the prime rate implies that household debt servicing costs will escalate in excess of 20% from current levels. This we deemed as a potentially destabilizing factor for higher risk credit providers.



Source: Bloomberg & Northstar Asset Management

3. African Bank's dangerous funding model:

African Bank was a retail focused credit provider funded by wholesale (institutional) depositors. In 2013, 85% of African Bank's funding was wholesale of nature. Wholesale depositors provide bulky deposits to banks - this funding is more expensive than retail deposits and less 'sticky' (it is easily removed). Wholesale funding squeezes the net interest margins that a bank earns and places pressure on its level of profitability.

4. African Bank's weak capital position:

Bank's capital position (this being the capital that banks are required to hold by the Regulator) declined to 15.1% in 2013 from much sturdier levels of 28.9% in 2009. Through 2013, African Bank became increasingly vulnerable to operational and financial shocks due to lack of capital.

5. African Bank's declining levels of profitability:

The bank's income yield (the yield generated on their loans) declined from 54.6% in 2005 to 33% in 2013. This occurred due to increasing levels of non-performing loans, increased levels of interest suspension and the in duplum impact on income (the in duplum rule limits the amount of interest that may be charged on outstanding debt and provides that interest may not exceed the capital amount outstanding).

6. African Bank's deteriorating loan book:

A few things worried us deeply about African Bank's loan book and these included:

- A consistent increase in the average size of the loans being offered to clients. The average loan size peaked at R14 000 in the first half of 2014 compared to R6 900 five years earlier. At Northstar, we viewed this as escalating the risk within the business model and it almost became a case of 'double or nothing'.

- A consistent increase in the average loan term - this peaked in the first half of 2014 at 55 months compared to 32 months five years earlier

In addition to increasing the average loan size, African Bank Management seemed at ease lending to clients for longer periods of time.

- Increased volumes of consolidation loans – African Bank consolidated the loans that their clients had with other credit providers under their umbrella and, in so doing, became the credit provider of choice.

7. African Bank's lack of conservative provisioning:

African Bank implemented a weak provisioning policy – the bank maintained a provision of 60% to 70% for non-performing loans, despite the fact that its loan book continued to deteriorate. In addition, it wrote off loans (considered them bad loans that were unrecoverable) after 17 months of non-payment by debtors. Compared to Capitec, which writes off risky loans after 3 months, African Bank's policy was clearly optimistic.

Conclusion:

As we stacked-up the evidence, our view was that African Bank was a fundamentally flawed business operating in an industry experiencing severe external and internal pressures. Clearly, the riskiness of the credit environment called for cautious financial and operational management and we did not feel that this was evident.

This synopsis of our decision on African Bank does not imply that the Northstar Research Team is immune from making mistakes. It does, however, demonstrate the thorough decision-making process which we follow to find **QUALITY** businesses, trading at correct **VALUATIONS** in which we can invest for long periods of **TIME**. In so doing, we are able to radically improve the odds of success.

The Northstar Research Team