NORTHSTAR

ASSET MANAGEMENT

**Client Letter** 14 February 2013

**Quarter End: 31st December 2012**



Dear Investor

This is the first newsletter and quarterly report being sent to you from Northstar which sadly, is not being written by Alexander Otten.

You will notice that our thoughts on the market are contained in our Northstar Quarterly report which we have attached for your interest, whereas this letter aims to inform you of our progress at Northstar.

Writing to our clients fills me with very mixed emotions. On the one hand, the deep sense of loss of a respected industry colleague who became a friend is ever present, whilst on the other hand; the honour of taking Alexander's hard work forward is motivating.

As many of our clients now know, Alexander asked me to act as his alternate Key Individual within Northstar, months before his tragic death. We were also discussing ways to work closer in 2013. It is difficult to articulate what a privilege it was to have had those discussions with Alexander, and it is tragic that we could not have worked together to build Northstar into an even better business than it already is.

The current team at Northstar shares Alexander's views and vision on the following:

- Investing takes hard work and patience, and buying great businesses and retaining them is a winning formula.
- An asset manager must have demonstrated an ability to produce sound long-term returns for clients.
- Asset management firms should strive to be the best for their clients, but not necessarily the biggest.

With this in mind, it is appropriate to inform you as to the process that has been followed since I joined the business full time in December 2012 and our progress:

- Understand all the systems and processes and ensure the credibility of these and where appropriate, enhance them further. Northstar had great processes and systems in place and our main input has been to try and automate manual processes.
- Assess each client's portfolio and ensure that we are comfortable with all the holdings contained therein. Not only are we completely au fait and at ease with all the stocks chosen by Alexander, but we estimate more than a 70% overlap between existing Northstar portfolios and the portfolios we managed for our clients in our previous roles.
- Meeting our Northstar clients and understanding their specific needs and wants. We are actively involved in this process at present and look forward to meeting you very soon.
- Building on the existing investment process which Alexander put in place at Northstar. We consider this to be the bedrock of sound investing and we are applying the best of all that we have learnt over two decades, to develop a deep seated investment philosophy and process at Northstar that is repeatable in the years ahead. This process needs to transcend any of us as individuals, and should act as the root DNA or genetics of the business.
- Employing only a few, but the very best people in the industry, to do justice to the requirements of our clients and to ensure that we generate sound long-term investment returns. To date, we have employed Mark Seymour; Mark is a highly experienced asset manager, having managed money for clients in South Africa for over 12 years. In addition to the outsource arrangement we have with research specialists, we intend adding one more industry research specialist to our team.

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The importance of building a robust infrastructure at Northstar cannot be emphasized enough, particularly considering the strong patronage from both new and existing clients over these past few months. Whilst this is exciting, our intention remains to retain the discrete nature of Northstar and the bespoke offering that you have become accustomed to.

Thank you for your continued support of Northstar Asset Management, and we hope that you find our thoughts in the Northstar Quarterly report of interest.

Please feel free to contact either Mark Seymour or myself anytime should you have anything you wish to discuss.

Yours sincerely

**Adrian Clayton**

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In this our final market report for 2012, we briefly reflect on the JSE's performance this past year and then revisit two key investment lessons. We conclude by discussing Sasol and why it forms an integral component of our portfolios.

**Reflecting on 2012:**

2012 was a particularly good year for our clients at Northstar Asset Management, markets were strong and the JSE was driven predominantly by blue-chip industrial companies, these being very well represented in our Northstar portfolios.

For the year (the ALL Share index excluding dividends) returned 22.7%. The Total Return index gained 26.7% but the Resources index, which constitutes almost 30% of the total market capitalization of the JSE, produced a mere 5.4% return. The final quarter of the year was particularly impressive; the All Share Index rallied 10%.

This past year, 83% of South African professional equity fund managers underperformed the All Share index and the largest SA Domestic Manager, underperformed the index by almost 10%. So whilst it was a great year for investors holding South African equities, it was a very difficult year for professional managers to outperform the overall market.

**Key lessons are repeated for disciplined investors:**

As we leave 2012 behind us and contemplate the New Year, one cannot help but draw on tried and tested lessons, two that are particularly pertinent right now are:

- ''You must be in it, to win it!''
- "Price does not equal value"

These are two seemingly contradictory statements, but in truth, they both guide serious investors towards holding a long-term valuation-driven mindset when investing.

The first point speaks for itself, at Northstar, we keep persuading our clients that timing the market is a fool's game. We are not chartists and claim little or no knowledge in predicting short-term price movements of any share, commodity, bond or currency for that matter. Instead we subscribe to the methods of astute investors, the likes of Benjamin Graham who famously said that ''in the short-term, the stock market is a voting machine, while in the long-term, it is a weighing machine''. So our approach is to build positions in quality companies at valuations we deem appropriate and wait patiently until the stock market prices the company in question at a higher level than our valuation.

The second lesson that price does not equal value, deals with the concept that share prices often deviate wildly from the underlying value of the companies they are supposed to represent. This occurs, as pointed out by Graham, because human emotions, the emotions of fear and greed drive prices in the short-term, but in the long-term, the market will revert to pricing a company based on its profitability – at what it is actually worth.

With this in mind, our investment philosophy at Northstar is defined as:

- ''Long-term exposures to quality assets where value exceeds price."

**Sasol – a quality business at a reasonable price:**

At a time when many of the companies, which we regard as our quality core holdings, have reached price levels which make them difficult to buy at present, Sasol offers a unique blend of quality and value. We base our interest in the Group on the following key features:

**1. Macroeconomic drivers:**

**1.1 Strong demand:**

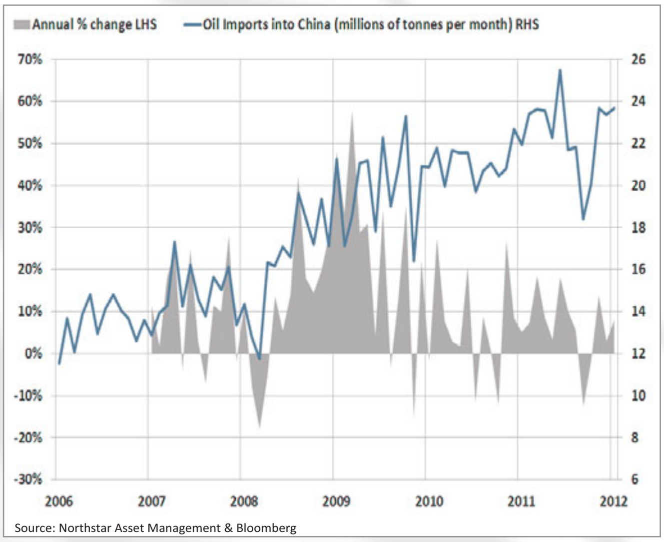
When the market refers to China and its impact on commodity prices, the usual focus is on 'hard' commodities. The best example is iron ore, of which China now constitutes 62% of the global market, where prices rocketed from about $11 a dry metric ton in 1998 to almost $190 in 2011.

While the oil market has also undoubtedly been lifted by Chinese demand, as the Chinese import 70% of their energy needs, we feel less concerned about the long-term price drivers for oil, relative to a hard commodity like iron ore. Harder commodities tend to enjoy their highest levels of demand during the early phases in a country's journey along a path of industrialization.

Massive infrastructural projects accompany such industrialization phases, as was the case in Germany after 1947 and Japan's ''priority production system'' that started in the 1950's. They focused on heavy industries such as timber and ship works, and then moved towards the production of large consumer products, such as cars in the 1960's and 1970's.

China has clearly been the country that has captured this mantle in later years; its industrialization started tentatively in the 1960's when 60% of its labour force worked on farms but by 1990, 30% of labour was farm based and its industrial machine then slipped into top gear with the same initial heavy industry focus. This played a big role in lifting beleaguered base metal markets in the late 1990's.

But China's growth path is now looking no different to the metamorphosis that all industrial nations go through. Industrialism shifts to consumerism and it is during this transition that harder commodities can encounter failing demand and price pressure. Energy consumption, on the other hand, is buoyed by income per capita gains; this is evidenced by US and European dominance in barrels per day of oil usage, the US consuming 10 times more oil annually than China, yet it contains 23% of China's inhabitants. 69% of oil utilized in the USA is for personal consumption in the form of people driving their motor vehicles. China overtook the US market in terms of passenger vehicle sales in 2009 and in the last few months, has now overtaken Europe too, as the largest passenger vehicle market on earth, selling almost 15 million vehicles annually. This continues to grow at high single digit percentages each year.



Source: Northstar Asset Management & Bloomberg

The above graph shows an erratic by clearly rising trend of oil imports heading into Mainland China with monthly imports now double what they were just 6 years ago.

**1.2 Limited long-term supplies:**

According to research from the Bank Credit Analyst, oil discoveries peaked in the mid 1960's. Whilst new oil discoveries are being made, these are in many instances deep-sea finds, or in areas where the cost of production (government taxes, royalties, security risks, environmentally sensitive areas etc.) force these to be classified as 'higher cost oil'.

Although debate rages whether we have seen ''peak oil'', there seems to be limited debate that we have passed ''peak cheap oil.''

Most oil experts believe that global oil demand, at the rate at which it is growing at present, will result in demand exceeding supply within the next decade.

At Northstar, we do not attempt to predict demand-supply fundamentals of opaque markets, oil being one of these. That said, we must acknowledge oil's increased consumption with improving living standards as the Emerging World demands larger and larger quantities thereof. Added to this, complex supply fundamentals threaten supplies in the long-term. Barring a radical emergence of substitutes or an economic implosion, we view this market dynamic as favouring volatile, but persistently high, oil prices.

**2. Sasol's domestic moat:**

Sasol has a 64% share in the Natref crude oil refinery in Sasolburg. Natref is South Africa's only inland oil refinery and supplies most of the energy needs to the northern interior of South Africa. With such a powerful and almost impenetrable domestic moat, Sasol produces relatively consistent levels of profitability and has strong cash flows from its domestic franchise which it, in turn, uses to fund its higher growth international expansion projects.

**3. Sasol technology:**

Sasol has as its core competency Fischer Tropsch Technology, a process that converts coal and natural gas into various forms of usable products. Products that emerge from this process include liquefied petroleum gas, kerosene and diesel. The coal-to-liquids technology is increasingly coming under scrutiny due to its environmentally unfriendly nature, but the current very low natural gas price has meant that a large arbitrage opportunity exists to convert cheap gas into products that would otherwise emerge from expensive oil.

Sasol is involved in various natural gas-to-liquids projects around the world; these include developments in Nigeria, Qatar and Uzbekistan. The Group also has investments in natural shale gas assets in Canada and the USA. Given time, these investments should act as the bedrock to enhanced global profitability and diversify away from South African income, which currently dominates the income statement.

**4. A shareholder friendly company:**

Sasol Management have been decent custodians of capital and the business has been very well managed over many years.

Since 2002, Sasol's return on invested capital has exceeded its weighted average cost of capital and while mistakes have been made in the past, which include the costly and poorly implemented Turbo and Escravos GTL projects and the acquisition of Condea, this has generally been the exception rather than the rule.

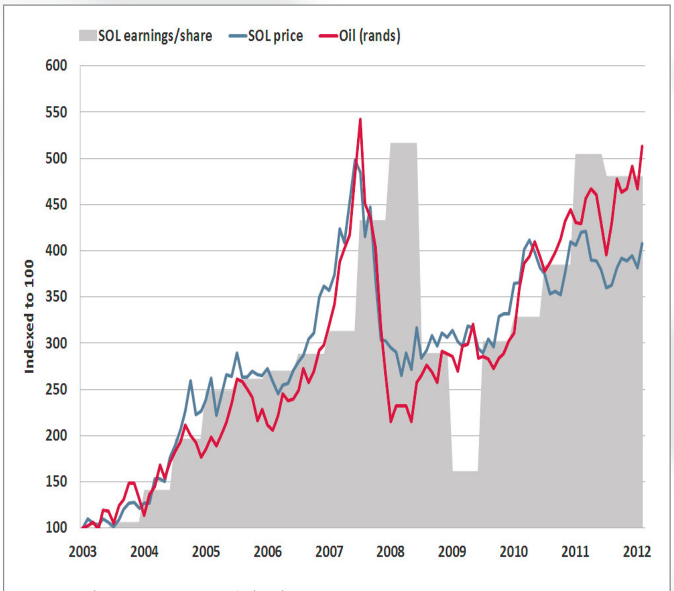
Over the past five years, the Group has applied capital in a manner which should make most shareholders extremely happy. This includes 31% of funds allocated to paying dividends and buying back shares, 28% used for expanding the business globally and 17% to paying down debt. This has meant that Sasol is now effectively un-geared or debt free (quite unique relative to peers) and pays a dividend of over 5% of its market capitalization annually.

Management has also set very specific targets for returns from projects, both domestically, which is 17.5% in Rand terms and abroad, 10% to 15% in Dollar terms, depending on the location of the project. It is also heartening to see how focused the investments are that Sasol makes, they are within their areas of competency, being Synfuels in South Africa and natural gas abroad.

**5. A compelling valuation:**

Clearly Sasol is highly dependent on the movements in two variables which we do not attempt to predict – the Rand/Dollar exchange rate and the global price of oil.

In the graph below, we show how closely the earnings of Sasol are influenced by the rand price of oil. What is also clear is that this has a major bearing, as one would expect, on the share price of Sasol. Sasol's share price closely follows the Rand oil price but this relationship has broken down somewhat of late. This either implies that Sasol is no longer influenced to the same extent by the price of oil in Rands (which is not the case), or that the market views oil as overpriced. Another way of interpreting the graph is simply that Sasol looks cheap relative to the oil price!



Source: Northstar Asset Management & Bloomberg

The weak Rand has assisted the Group this past year and continues to be an active tail wind; thus acting as a catalyst for record half yearly headline earnings per share to 31 December 2012.

Margins do however look quite elevated at present and we would not be surprised to see them retreat within certain underlying business units. The potential for write-downs in assets, such as their investment in Iran, is on the cards. We are aware that Sasol faces other challenges such as potential competition fines, product pricing regulation changes, carbon taxes and further asset impairments.

The stock currently trades on a normalized P/E of only 7.5 times with a dividend yield in excess of 5%. Considering the heady valuations applicable to certain other companies on the JSE, we feel that Sasol offers compelling value for our clients with a medium to long-term investment horizon.