FLAGSHIP ASSET MANAGEMENT

Flagship Quarterly Telescope *at 30 September 2019*

Welcome to our QUARTERLY TELESCOPE. We hope these quarterlies provide you with greater insight into our thoughts on global assets, as well as how our global funds are being managed. In this quarter's Telescope, Kyle updates us on some of the happenings globally and at Flagship, and also takes us through the investment case for DS Smith, a large holding in the Flagship Global Funds.

Dear investor,

The 3rd quarter of 2019 brought further excitement *and* apprehension to an already event-laden 2019. Political tensions continue to dominate the global narrative, reflected in the on-again off-again trade war between China and the US; the increase in the likelihood of a no-deal Brexit; and the continued political protests in Hong Kong. Now entering their seventh month, the protests are taking their toll on the city's economy, with August retail sales registering a -23% fall – the steepest decline on record. As if all of this wasn't enough, a Democrat-led process to impeach the US president was initiated on September 24th.

Economically, during the 3rd quarter the Fed further eased already accommodative monetary policy and, at Flagship, we continue to scratch our heads at the end-game to miniscule interest rates (discussed in our Q2 '19 Quarterly Telescope[1]).

In South Africa, relative underperformance of local assets compared to global assets continued, with the JSE gaining 7% YTD versus 17% for the MSCI ACWI. A deteriorating economic and fiscal situation - accompanied by continued government inaction - was largely to blame. A government white paper on ending private healthcare, as well as rising support for the reintroduction of prescribed assets, has raised already high levels of investor concern. As a reminder, should asset prescription become policy, local pension funds will be forced to buy certain types of assets (mostly government and State Owned Enterprise bonds) regardless of their investment merit, allowing government to borrow money at meaningfully lower rates.

In our view, reintroducing prescribed assets, last seen under the apartheid government in the 1980's, will harm the progress that has been made since 1994 in opening up South Africa's economy. Should the reality of prescription appear on our horizon, you can be certain Flagship's asset allocation to the South African economy will be tailored accordingly.

We are pleased to say that the political and economic ructions of the 3rd quarter have had very little impact on the companies we hold on your behalf. This is largely due to their robust business fundamentals that enable them to outperform through choppy environments; and to our valuation discipline that enables us to buy these businesses at a margin of safety. Due to our fundamental adherence to a long-term investment horizon, the bulk of the short-term news flow, heard or read, should have little or no bearing on our assessment of your investments.

At Flagship

The 3rd quarter has been a busy one at Flagship. We keenly anticipate the launch of our new fund, the *Flagship Global Icon Fund*, a global equity fund that will provide clients with 100% exposure to a collection of high quality, undervalued global stocks, many of which we also hold in our *Flagship International Flexible* and *Flagship IP Worldwide Flexible Funds*. The *Flagship Global Icon Fund* will offer both USD and ZAR entry points, easily accessible via Flagship's office or on local and international investment platforms.

We have also implemented strategic changes to the underlying assets of the *Flagship IP Worldwide Flexible Fund of Funds*. The intention of the change is to include a 'basket' of best-in-class, global equity funds, providing our investors with the following fund attributes:

[1] https://www.flagshipsa.com/market-commentary/

- Exposure to top performing global funds, normally only accessible to institutional investors
- Reduction of 'single manger risk' by diversifying underlying assets to a portfolio of world class fund managers
- Lower overall fund management fees due to our ability to bulk our investments into the funds

Importantly, the *Flagship IP Worldwide Flexible Fund of Funds* will retain its flexible mandate, allowing our Global Fund Management Team to increase or decrease equity exposure depending on global equity market valuations.

DS Smith – Underappreciated and misunderstood

One of the central aims of our Flagship QUARTERLY TELESCOPE is to introduce our investors to the investment cases behind our larger fund holdings. As of Q3 '19, *DS Smith* is the largest equity holding in our global equity strategies and, below, we detail for you the rationale behind our position's sizing.

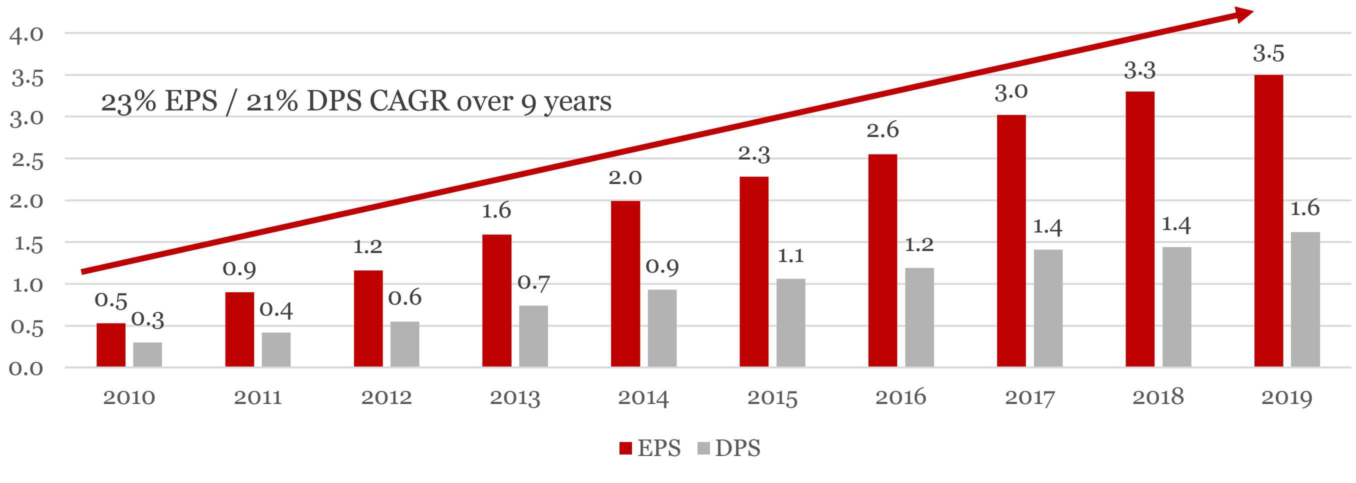
DS Smith is one of the largest paper and packaging companies within Western Europe (together with Smurfit Kappa and Mondi) with a market share of 20% in 2018. Although it is listed in London, the UK makes up only 16% of its revenues, with the balance coming from mainland Europe and the US.

We are positive on the broader structural drivers impacting the paper and packaging industry, and note the following tailwinds for companies operating in the sector:

(1) Greater demand for packaging in general (due to e-commerce, the move away from big-box formats to convenience store formats);
(2) greater demand for *value-added* packaging in particular which results in an increased box conversion margin because the value they add can be more easily demonstrated to clients (an example would be right-sizing packages for e-commerce so less 'air' is shipped); and
(3) an increasing trend towards environmental sustainability (consumers favour paper over plastic).

DS Smith has been an incredible success story since the arrival of current Chief Executive Miles Roberts. With a background in fast moving consumer goods ("FMCG"), he has changed *DS Smith's* culture from being a commodity producer of paper towards being a customer centric "box-maker" for the FMCG industry (whose demand for paper is more stable).

This strategy has borne fruit. Since Roberts' appointment in 2010, group revenues have tripled from GBP2bn to GBP6bn and adjusted earnings per share (excluding amortization) have increased from 5.3 pence to 35 pence per share (up 7X). While share price performance has also been excellent, it has undershot EPS performance, having grown "only" 4X.

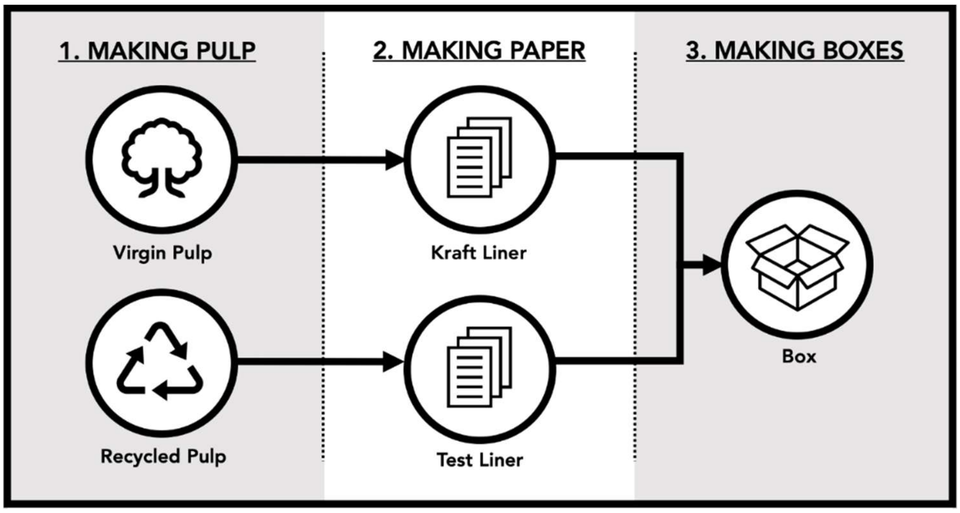


Source: DS Smith, all amounts in pence per share

In the discussion below, we will frequently draw comparisons between Mondi and *DS Smith* to enable you to understand *DS Smith* a bit better, as Mondi is a company that many of our South African investors will be very familiar with.

First, let us get to know how paper is made.

The paper and packaging industry



There are 3 basic stages in the paper and packaging process (illustrated in the diagram, above):

(1) Making pulp: There are two types of pulp - virgin pulp, which is made from freshly grown wood and is the primary input into kraftliner; and recycled pulp, which is made from old corrugated containers and is the primary input into testliner.

(2) Making paper: Whilst kraftliner and testliner are not the only types of paper, they are the two we shall focus on for the purposes of this discussion. These types of paper are primarily used to make boxes.

Kraftliner and testliner should be viewed as commodity products because any person with sufficient capital can build a new paper mill. The direct consequence of this is that the paper industry is cyclical. When paper prices are below their equilibrium level, very few new paper mills are built, resulting in demand for paper exceeding supply. Conversely, when paper prices are above their equilibrium level for a sufficiently long period, new milling capacity is built, increasing paper supply and culminating in paper price declines.

(3) Converting paper into boxes and other products: This is the final stage in the chain. While making boxes is considered a low value-add activity by some, boxes are not a commodity product because they are often built around a client's specific requirements. Box-making contracts are typically structured as cost-plus contracts where box makers pass through the cost of the paper onto their clients. The "plus" part depends on the negotiating power of the client as well as how sophisticated his requirements are.

What distinguishes *DS Smith* from Mondi is the different degrees they each focus on (1), (2) or (3) –

Making pulp: Mondi makes virgin pulp from wood which it buys in from third parties (or grows on its own plantations), while *DS Smith*, as the largest recycling company in Europe, predominantly makes recycled pulp from the 5 million tonnes of paper it collects annually.

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Making paper: Because Mondi mainly produces virgin pulp, the primary paper product it produces is kraftliner while the primary paper product *DS Smith* produces is testliner. This distinction is important as certain end use products are required to use kraftliner (i.e. certain food products), while others use testliner because it is cheaper.

There is, however, a second difference between the two companies which relates to *how much* paper each of the two companies produce –

Mondi produces more kraftliner than it can convert into boxes itself which means the majority of the kraftliner it produces is sold to third parties who convert it into boxes. In industry parlance, Mondi is "long" paper.

DS Smith follows a different strategy. It does not produce sufficient paper for its own box-making requirements. The reason for this is that they want to be less exposed to the price of paper, which they rightly view as a commodity product with poor pricing power. It therefore buys in both testliner and kraftliner from third parties. In industry parlance, *DS Smith* is "short" paper.

DS Smith's goal is to produce 60% of the paper it needs for its box-making operations.

Converting paper into boxes and other products: Finally, Mondi doesn't focus solely on box manufacturing but also manufactures industrial bags and even graphic paper. *DS Smith* focuses solely on boxes. For our purposes, this is the final (although least significant) difference between Mondi and *DS Smith*.

In sum, the primary differences between DS Smith *and Mondi are that: (1) DS Smith focuses on recycled pulp whereas Mondi focuses on making virgin pulp, (2)* DS Smith *could be described as a "box-maker that also makes paper" (because it is short paper) while Mondi is better described as a "paper-maker that also makes boxes" (because it is long paper) and (3)* DS Smith *makes boxes whilst Mondi produces other products as well.*

Over the last 12 months the share prices of all the European paper companies have fallen considerably, primarily because the outlook for paper prices (both kraftliner and testliner prices) have deteriorated. Kraftliner prices have fallen because erstwhile high kraftliner prices have incentivized players to bring on a lot of new kraftliner capacity, especially in the US where there is an abundant supply of virgin pulp. Testliner prices have fallen because China has placed a moratorium on the importation of old corrugated containers to encourage its domestic recycling industry to develop.

Interestingly, the share price of *DS Smith* has performed in line with Mondi and underperformed Smurfit Kappa, despite the fact that it is less exposed to the paper price than either of these companies (see table, below).

Total shareholder return of DS Smith versus Smurfit Kappa and Mondi over the past 12 months

Range 10/01/2018 - 09/30/2019 Period Daily No. of Period 364 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	SMDS LN Equity	USD	-29.57%	-26.99%	-5.16%	-27.06%
2)	SKG ID Equity	USD	-24.73%	-21.84%	--	-21.89%
3)	MNDI LN Equity	USD	-30.55%	-27.52%	-5.69%	-27.59%

Source: Bloomberg

It is impossible to conclude definitively on the reasons for this but, possible reasons are: (1) *DS Smith* is more financially geared than Mondi post a large acquisition which it concluded last year, (2) Mondi's returns on equity are higher than those of *DS Smith*, and (3) there is execution risk in *DS Smith* delivering on its latest acquisition.

In our analysis, all of these concerns *can* be rebutted –

It is true that *DS Smith* is more geared than Mondi as it has an adjusted net debt to EBITDA ratio of 2X post the sale of its plastics business (versus 1.3X for Mondi), but its net debt to EBITDA ratio is within the company's target range of "below 2X". It has de-geared quickly when it has made acquisitions in the past due to its high cash conversion ratio.

Whilst *DS Smith's* historic returns on capital and equity are lower than Mondi's, we believe much of this can be attributed to the fact that Mondi bought many of its Eastern European operations at bargain basement prices. This flatters historical returns, and hence we believe incremental returns on capital at *DS Smith* are in line with Mondi's.

With respect to the execution concerns from the acquisition by *DS Smith* of Europac, we take comfort from the fact that *DS Smith* has successfully acquired and divested many companies since 2010, and our frequent interactions with management over the past few years lead us to believe that this acquisition offers no greater difficulties than previous ones. We note, positively, that management have already upgraded the synergies they expect to deliver from the acquisition.

DS Smith has one more ace up its sleeve. In 2018 the Company acquired a small, family-run box manufacturer in the US, called Interstate. While currently a small part of its business, we believe the successful growth of this acquisition means it has the potential to be a much larger contributor in the future. Our research leads us to believe that through Interstate, *DS Smith* is able to provide its existing clients in Europe with cheaper packaging solutions than can currently be provided by American paper companies – largely due its deep experience in FMCG packaging, and because the lower kraftliner prices in the US have acted as a disincentive for American packaging companies to innovate.

DS Smith currently trades at a P/E multiple of 10X and a dividend yield of 5%. We believe this valuation underappreciates the quality of the business as well as its prospects over the next 5-8 years. The low valuation, as well as the structural and company-specific tailwinds, limit downside, and accordingly **makes it a top holding**.

Summary

The Flagship global investment team focusses on allocating investors' capital to the highest return assets in our mandated universe. We also follow the time-tested philosophy of investing for the long-term, steadfastly avoiding the siren call of the dangers of short-term thinking. There are few places where this is more apparent than with *DS Smith*.

Please contact the team at Flagship if you have queries regarding your investment with Flagship, or if you would like to speak to one of the portfolio managers. Our door is always open. We thank you for your continued support.

Winston, Kyle and Pieter



Flagship's three global funds provide investors with exposure to a collection of global assets that trade at a meaningful discount to their fair value. We adhere to a valuation-based investment philosophy, and our funds are constructed without reference to a benchmark. The equity holdings in our global funds consist of high-quality businesses that compound returns over long periods of time; generate high levels of free cash flow; and demonstrate considerable potential for growth.