Flagship Quarterly Telescope – Q1 2020

*Welcome to our latest 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 Wales** and **Pieter Hundersmarck** discuss how our portfolios are positioned to weather the COVID-19 crisis, and **Kyle Wales** discusses the investment case for US retail chain, **Dollar Tree**, a holding in Flagship's global funds.*

Dear Investor,

Firstly, it is important that all our investors understand that Flagship is 100% operational and the investment team is actively managing all portfolios during this time. Please feel free to contact us should you wish to discuss your portfolio in greater detail.

At Flagship, we have been closely monitoring the economic impact of the Coronavirus since February. On March 2 we wrote about how we were preparing for the impact in our funds here. In that commentary we said:

"*For the next few months, holidays, conferences, business meetings and trade shows will be cancelled across the globe. Airlines, airports, hotels and related travel industry participants will be impacted. The oil price, which depends on the demand for fuel, will be negatively impacted. Companies with supply chains dependent on China, such as consumer electronics and IT hardware businesses, will struggle to manufacture products and will lose sales. Consumption at restaurants and shopping malls will fall*"

Much of this has come to pass. Since we last updated you, countries across the globe have taken unprecedented responses to curb the spread of the virus, with over 3 billion people now subject to some form of lockdown.

World leaders have decided that the best approach to combat the spread of the virus is for entire countries to close their borders and shut down all but essential businesses, government, and services. As we enter April, millions of people worldwide have lost their jobs and are dependent on governments for support. Businesses are in cash preservation mode.

Coupled with this has been the *de facto* collapse of the OPEC+ alliance as a result of Saudi Arabia deciding to flood the market with crude to force high cost producers (like the shale producers of North America) out of the market. In ordinary circumstances, this might have been seen as a positive development because it could be construed as a form of "fiscal stimulus" which would support consumption at a time of uncertainty. Coupled with the collapse in demand as a result of the COVID-19 crisis, however, it has only added to the prevailing uncertainty.

In response, the US Federal Reserve has cut rates by 150 basis points to near zero and run through its entire 2008 crisis handbook of asset buying programs. Central Bankers around the world have followed suit, ensuring that credit markets continue to function properly. They have learned their lessons from the Great Depression which was made deeper and longer due to the inaction of monetary and fiscal policy at that time.

Global stock markets predictably sold off. The MSCI All Country World Index ("MSCI ACWI") fell 25.1% in a record-breaking 16 trading days (by March 23) before recovering to end the month down 13.7%. If taken from the peak reached on Feb 12, the index fell 33.9% from peak to trough. The oil price also imploded, trading at its lowest level in decades.

This is some of the most extreme volatility we've seen in 15 years. The selloff has brought an end to the 236% cumulative rise in the MSCI ACWI since March 2009; and today the index is back at a level not seen since April 2017.

This is not 2008

As bad as things seemed in the depths of March, this is not 2008. Then, the leverage in the financial system was the main culprit for the stock market crash. Real estate speculators had fuelled the bubble without doing proper due diligence while investment banks (who had leveraged their books about 40 to 1) provided the funding. This created a wave of contagion which caused the entire system to collapse.

Leverage in the form of imprudent margin lending against stocks was the cause of the Great Depression. It was also the cause of the emerging markets crises of 1997/8 when over-indebted countries experienced a run on their currencies.

In the *current* selloff, the origin lies on main street, not Wall Street. The steps taken to curb the spread of the coronavirus have caused economies around the world to 'suddenly stop', preventing the free flow of trade, people and capital. *To be sure*, this can and likely will lead to a severe drop off in economic activity for the next year, but the key ingredient to financial institutions failing which is over leverage is missing.

In this respect, the base case would be more akin to the short, sharp sell-offs which have accompanied the declaration of war during both World Wars and the Gulf War, or to the Oil Crisis of the 1970's.

What actions have we taken in our global funds?

Performance – all figures to March 2020, in ZAR

Offshore Funds (ZAR)	March	YTD	1 YR	3 YR
Flagship IP Worldwide Flexible FoF	3.0%	8.1%	8.2%	26.1%
AVERAGE -- W/W - Multi Asset Flex	*-4.9%*	*-4.4%*	*0.0%*	*12.5%*
Outperformance	**7.9%**	**12.5%**	**8.2%**	**13.6%**
Flagship IP Worldwide Flexible Fund	0.7%	0.8%	3.8%	13.8%
AVERAGE -- W/W - Multi Asset Flex	*-4.9%*	*-4.4%*	*0.0%*	*12.5%*
Outperformance	**5.6%**	**5.2%**	**3.8%**	**1.3%**

In the **Flagship IP Worldwide Flexible Fund ("FWFF")** and the **Flagship International Flexible Fund ("FIFF")**, we mentioned on March 2 that we had 30% of the fund in gold and cash. The market turbulence provided opportunity, and the global team used March to build positions in existing as well as exciting new stocks that were sold off indiscriminately. The prices we achieved bode well for future returns.

As you may recall from our February factsheet, our 10 largest equity holdings in March were:

	Company	Position size[1]	Business description
1	Netease	5.4%	Chinese gaming company
2	Alibaba	4.7%	Chinese e-commerce
3	Facebook	4.4%	Social media
4	Microsoft	4.1%	B2B software
5	Heineken Holdings	3.8%	Beer
6	Alphabet (Google)	3.6%	Search engine
7	Reckitt Benckiser	3.6%	FMCG
8	DS Smith	3.5%	Packaging manufacturer
9	British American Tobacco	3.4%	FMCG
10	Zalando	3.4%	Online fashion retailer
		39.9%	

[1] Position sizes based on FIFF as at 28 February 2020 (i.e. going into the crisis) but would have been similar in FWFF as well

Of these, four experienced no adverse impacts from the COVID-19 crisis at all: Netease (which benefitted from increased propensity to play video games while China was in lockdown), Microsoft, Reckitt Benckiser and British American Tobacco.

The remaining six were only mildly impacted by the COVID-19 crisis. Alibaba and Zalando were impacted by reduced consumer discretionary spend but, as e-commerce players, were the least badly affected amongst retailers. Facebook and Google were impacted by the prospect of reduced advertising spend as businesses sought savings to compensate for the reduction in their revenues, but the longer term outlook for online advertising spend still remains robust. Finally, Heineken suffered from the prospect of a decline in on-premises consumption (i.e. consumption in restaurants and bars), while DS Smith has been impacted by reduced demand for paper boxes. We believe both these impacts are short term.

The funds diverse geographic and sectoral holdings protected capital during the fall. Diversity, as market parlance goes, is the only ‘free ride’ in investments. Despite holdings in property companies Hammerson and Unibail falling in excess of 70% for the month, these positions were appropriately sized beforehand which has mitigated their impact on portfolio performance.

LVMH and Adobe

As well as adding to our high quality stocks, we also initiated positions in **Adobe**, a leading software provider to the creative and marketing industry, and **LVMH**, the highest quality pure-play luxury business in the world. We are excited to share these investment cases with you in upcoming Quarterly Telescopes.

The value of the funds’ gold position stayed constant throughout the month, versus a decline of 13.5% in the MSCI ACWI index (USD). Gold is either loved or hated by the investment community, but in times like these, there are few better ways to hedge the portfolio from downward market volatility.

We would reiterate here that risk management in the funds is not a hat we ‘put on’ during times of trouble, but is rather interwoven into the day-to-day review and management of each of the positions and the portfolio as a whole.

For the month of March, as well as year to date, the global funds have outperformed the MSCI ACWI as we expected they would.

Manager selection and flexibility

In our Flagship IP Worldwide Flexible Fund of Fund, we started the month with equity exposure of 73%. We similarly added equity exposure to the portfolio as markets fell, assisting the fund to continue to outperform.

The two main reasons for this outperformance are – manager selection and the fund’s flexible mandate.

Firstly, five out of our six global managers in the fund outperformed the MSCI ACWI, both YTD and for the month of March. While this outperformance was what we were aiming for, we are nonetheless pleased by this testament to the blend of managers selected, and are satisfied with the styles performing the way they should in a declining market.

Secondly, we entered the year with low equity exposure and therefore didn’t participate in the market turbulence as much as a fully invested fund would have. We therefore benefitted on both sides of the coin: low exposure as markets fell, and the exposure we *did* have performed better than the market.

We are pleased to share with you the addition of **Guinness Global Innovators** to the Fund of Funds. This fund is managed by a capable two man team out of London and we will share more about them in upcoming communication.

What is our current view? Cautious optimism….

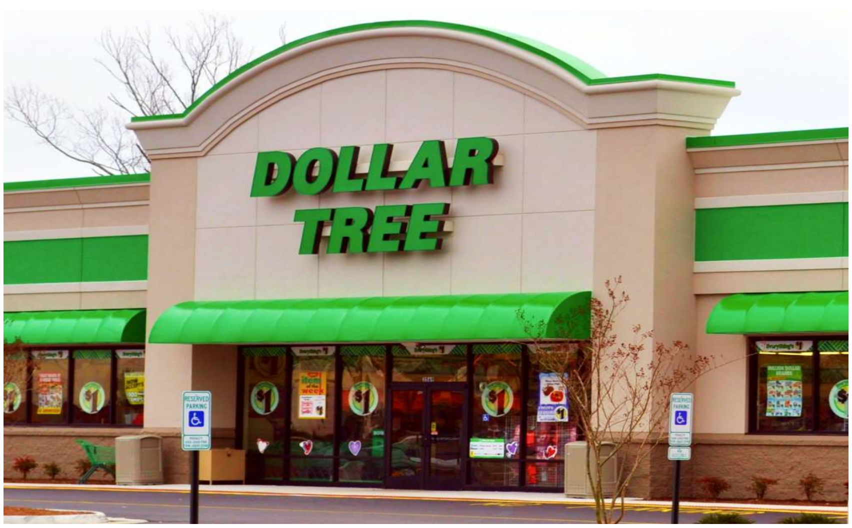
We are realistic about the effects of the economic stoppages on our portfolios and how this would affect the companies we own, potentially causing their share prices to react negatively. It would be imprudent to expect that any company – no matter its quality – can withstand a standstill to its revenues. Because of this, we hold a balance of defensive and growth orientated businesses. We observe that companies in the defensive sectors of food retail, online gaming, online services, healthcare, and tobacco are performing well. We also hold reasonably priced growth businesses in structurally attractive niches.

There are reasons for cautious optimism. We know that, ultimately, the pandemic will end, and the steps taken by governments and central banks will ease the economic pain caused by the quarantines and lockdowns. Despite this, we maintain a cautious stance. We do not know how deep the upcoming weakness will be or how long it will endure. Whatever the future may hold, we view our principal responsibility as preserving and growing our investor's capital.

Although we expect heightened volatility and a weaker economic backdrop, we believe that all of our companies will eventually recover, and create substantial value over the long term.

The investment case for US retail chain, Dollar Tree

Dollar Tree – For the thrifty shopper



Quick take

- Dollar stores play an important part in the US retail landscape as fill-in and variety trade for a cohort of value-focused consumers.
- Their scale, footprint and operating metrics make them high quality businesses.
- While competitors like Dollar General make higher margins, they also trade on much higher multiples.
- The acquisition of Family Dollar has dampened Dollar Tree's true earning power, and on a normalised basis we believe earnings should be far higher.
- The COVID-19 crisis afforded us an attractive entry point to add to our holdings.

An integral part of US culture

Dollar Tree is a “dollar store” which is a retail concept unfamiliar to many South Africans. A dollar store can be likened to a “Crazy store” in South Africa but it carries an assortment of consumable items so it’s customers can use it for quick fill-in shops as well.

Dollar Tree first listed in 1995. Since then it has delivered 17% total return per annum, meaning that a $10,000 investment at listing would have increased over 50-fold to $506,000. While it has been an incredible performer over long periods of time, it has stumbled over the past 5 years as the table shows.

% return, not annualised	1 YR	3 YR	5 YR	10 YR	15 YR	20 YR
Dollar Tree	-29.9%	-7.0%	-10.1%	263.0%	800.4%	534.3%
S&P Index	-12.1%	10.9%	32.3%	168.0%	204.9%	154.7%
Out/underperformance	***-17.8%***	***-17.9%***	***-42.4%***	***95.0%***	***595.5%***	***379.6%***

The weak performance over the past 5 years is attributable to the acquisition of Family Dollar, which will be discussed further below. However, on top of this, it too is a consumer discretionary stock and has also been impacted by the fall-out from COVID-19. The current sell-off therefore provides a compelling entry point into the stock.

The Business

According to its narrowest definition, a dollar store is so named because all the items in the store sell for $1 or less. Over time the original definition of a “dollar store” has expanded to include any small-box retailer which sits within close proximity to its customers and whose value proposition is selling low priced items.

Dollar Tree trades under two distinct banners:

- *Dollar Tree*, comprising just over 7,000 stores in the US and Canada. This is its most profitable banner and the one after which it is named, accounting for half its store network and revenue, and;
- *Family Dollar*, comprising over 8,000 stores which it acquired in 2016 and which accounts for the other half of its store network and revenues.

The Dollar Tree banner is the only dollar store banner that has stuck to its original pricing policy of selling everything for $1 or less while Family Dollar, its acquired banner, and Dollar General, its largest competitor, have all deviated.

Dollar Tree holding company

Dollar General holding company

Above: A combination of Dollar Tree and Family Dollar compete against Dollar General

What does a dollar store look like?

In accordance with the definition above, the following are the most noteworthy characteristics of a dollar store:

- *Low price points*. Whether it is Dollar Tree which is constrained by a $1 price point or Dollar General which isn't, a defining feature of dollar stores is that they sell items at low price points. They manage to do this by offering non-branded (or white-labelled) products as opposed to branded products. In the case of Dollar Tree where there is a $1 price point constraint, they adjust their pack sizes, if necessary, to ensure all their stock keeping units ("SKUs") are below the $1 price point. Low price points do not necessarily mean "value for money" as items purchased from dollar stores are often more expensive on a per-kilogram or per-litre basis.

- *Poorer customers*. Because of their focus on lower price points, it comes as no surprise that Dollar Tree and Dollar General focus on less affluent customers. Interestingly, the typical Dollar Tree customer is more affluent than the typical Dollar General customer despite the fact that Dollar Tree is constrained by a $1 price point. The reason for this is that Dollar Tree's focus is on non-consumable items and therefore attracts suburban middle-income shoppers who are shopping around an occasion (like buying greeting cards for a birthday party, for example) while Dollar General attracts poorer people who are doing their everyday shopping.

- *Convenience*. Dollar Tree and its rival Dollar General each have 15,000 stores on a consolidated basis. By contrast America's largest retailer by revenue, Walmart, has "only" 4,700 stores. The reason for dollar stores having such large store networks is because a large part of their value proposition is proximity to their customers and this requires them to have denser networks of smaller stores. Dollar Tree stores are typically based in suburban areas and Family Dollar Stores are in rural areas.

- *Fill-in shops.* Both their low price points as well as the smaller size of their stores means that dollar stores offer a more limited assortment of SKUs. The average dollar store carries 10,000 SKUs versus the typical Walmart which carries 90,000 SKUs. They are thus often used for fill-in shops when it is inconvenient for their customers to drive to their closest Walmart.

Why are dollar stores good businesses?

Regular readers will know that we have a preference for high quality businesses with one attribute of these types of companies being that they are less at risk from competition and disruption. High quality refers to the return on assets, the defensiveness of the business, the profit margin structure as well as the moat around the business.

In the case of the dollar stores, we believe the following characteristics make their businesses high quality:

- *It is hard for new competitors to enter their catchment areas*. This is due to the density of their store networks because the profit pool is simply not large enough to support an additional competitor.

- *Scale and sophisticated global supply chains*. This is necessary for them to source all manner of items at the lowest possible prices. These are hard to replicate.

- *Digital disruption.* This seems to be less of a risk for dollar stores than other types of retail businesses. The reason for this is twofold. Firstly, because they are used for fill-in shops they satisfy a need that cannot be anticipated far enough in advance to be addressed by online shopping. Secondly, because their customers are less affluent they are not prepared to pay a premium for the convenience of shopping online.

- *Free cash flow.* In an average year, Dollar Tree manages to convert 81% of its Net Income into Free Cash Flow. The low reinvestment needs of the business as well as supplier terms enable this.

- *Return on invested capital (ROIC).* Prior to the Family Dollar acquisition, Dollar Tree enjoyed ROIC of c.30% annually.

Why do we own Dollar Tree but not Dollar General?

We are not buyers of assets – even good assets – at any price. The reason why we own Dollar Tree as opposed to Dollar General comes down to price.

Dollar Tree and Dollar General trade at multiples of 14.7X and 19.9X respectively on a blended forward basis (as at 31 March 2020). This is despite the fact that Family Dollar, which accounts for roughly half of Dollar Tree's store base and revenues on a consolidated basis, makes no money.

Should Family Dollar earn a fairer margin for a business of this type, Dollar Tree's multiple would be half of its current multiple. We thus believe we are paying a fair (even a low) price for the Dollar Tree banner only and getting Family Dollar for free. The market is thus taking a very grim view of Family Dollar's prospects.

We are more optimistic.

At the time Dollar Tree acquired Family Dollar, the market underestimated the length of time that it would take Dollar Tree management to turn an organization of this scale around. Until now, however, many improvements have been made at Family Dollar but they have yet to bear fruit.

Firstly, while the number of Family Dollar stores has remained broadly flat, underlying this has been an elevated number of store closures which has been offset by an elevated number of new store roll-outs because management are trying to increase the number of Family Dollar stores within rural areas and decrease the number of stores within urban areas. Unfortunately, this has been very punitive on margins because store closure costs are expensed up front while new stores are initially margin dilutive because they take a while to reach mature trading densities.

Secondly, by the time Dollar Tree reported its 3Q20 results, management had reformatted 1,460 (out of a total of 7,815) of its Family Dollar Stores. Similar to both store roll-out costs and store closure costs, store reformatting costs are also incurred upfront but the benefits take a while to flow. The reformatted stores have seen an increase in same-store sales post-reformatting of 10%, however, and there is no reason why the additional 1,000 stores which management aims to reformat in calendar 2020 should not see a similar uplift in same-store sales.

Hindsight is a perfect science and it is easy to forget that Dollar Tree was not alone in thinking that Family Dollar would make a great acquisition even though the reality has not turned out to be so rosy. Dollar General was actually prepared to pay more for Family Dollar than Dollar Tree was, despite the fact that Dollar Tree eventually won out.

What are we forecasting for Dollar Tree?

For both the Dollar Tree banner as well as the Family Dollar banner we are forecasting low single digit increases in sales per annum. In the case of the Dollar Tree banner, this is primarily led by new store roll-outs. In the case of the Family Dollar banner, it is primarily led by same-store sales growth as there are no net new store additions planned for this banner.

From a margin perspective we are forecasting flat margins at the Dollar Tree banner while we are forecasting for margins to expand at Family Dollar. This is due to increasing penetration of non-consumables and private label brands driving gross margin expansion, while increase in trading densities (sales per square metre) results in better absorption of selling, general and administration ("SGA") costs.

Finally, we believe Dollar Tree is a premium business and therefore think it deserves to trade at a higher multiple than the US market average (16X over the last century).

In conclusion

For many of you, we are the caretakers of a large portion of your global investments. We would like to use this opportunity to thank you for the trust you place in us, and emphasize how deeply committed we are to the responsibility you have placed in our hands. Despite the uncertainty that the next months will bring, we remain confident that we can achieve the objectives of all our funds and help you navigate through this difficult period, just as we have helped you navigate through the last 18 years.

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

Regards,

Pieter, Kyle and Winston



Established in 2001, Flagship is an independent, specialist global asset manager. We run three distinct global strategies: Equity, Flexible and Fund of Funds. We follow a robust, common sense approach to investment management founded on fundamental principles and believe that long-term, focused, valuation-based management is the best way to manage our investor's capital.