



# FLAGSHIP

ASSET MANAGEMENT

Quarterly Telescope Q2 2022

# 01

## We are a global specialist investment boutique

Flagship is a specialist global asset manager founded in 2001.

We are 100% independent and fully owned by staff and directors.

Our mission is to be the navigators and global authority of your complete investment future, wherever it may lead.

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# 02

## We manage global portfolios in three distinct strategies

Global Equity | Global Flexible | Global Fund of Funds

We believe in a focused approach to fund management

Our longest running Funds have track records spanning over two decades

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# 03

## We are long term investors who manage concentrated portfolios

Our investment approach is process-driven and rigorous, and our definition of quality is demanding and exclusive.

Our equity portfolios are focused. We own a maximum of 25 shares, diversified across geography and sector.



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# The Flagship Global Investment Team



## Pieter Hundersmarck

Pieter is the co-manager of the global funds at Flagship and has been investing internationally for over 15 years. Prior to Flagship he worked at Coronation Fund Managers for 10 years and also co-managed a global equities boutique at Old Mutual Investment Group. Pieter is a dual Dutch and South African citizen, and he holds a BComm (Economics) from Stellenbosch University and an MSc Finance from Nyenrode Universiteit in the Netherlands.



## Kyle Wales CA (SA), CFA

Kyle is the co-manager of the global funds at Flagship and has been investing internationally for over 14 years. Prior to Flagship, he worked at Coronation Fund Managers for 9 years in the Global and Global Emerging Markets teams and also co-managed a global equities boutique at Old Mutual Investment Group. Kyle is a South African citizen, a qualified chartered accountant and CFA charter holder.



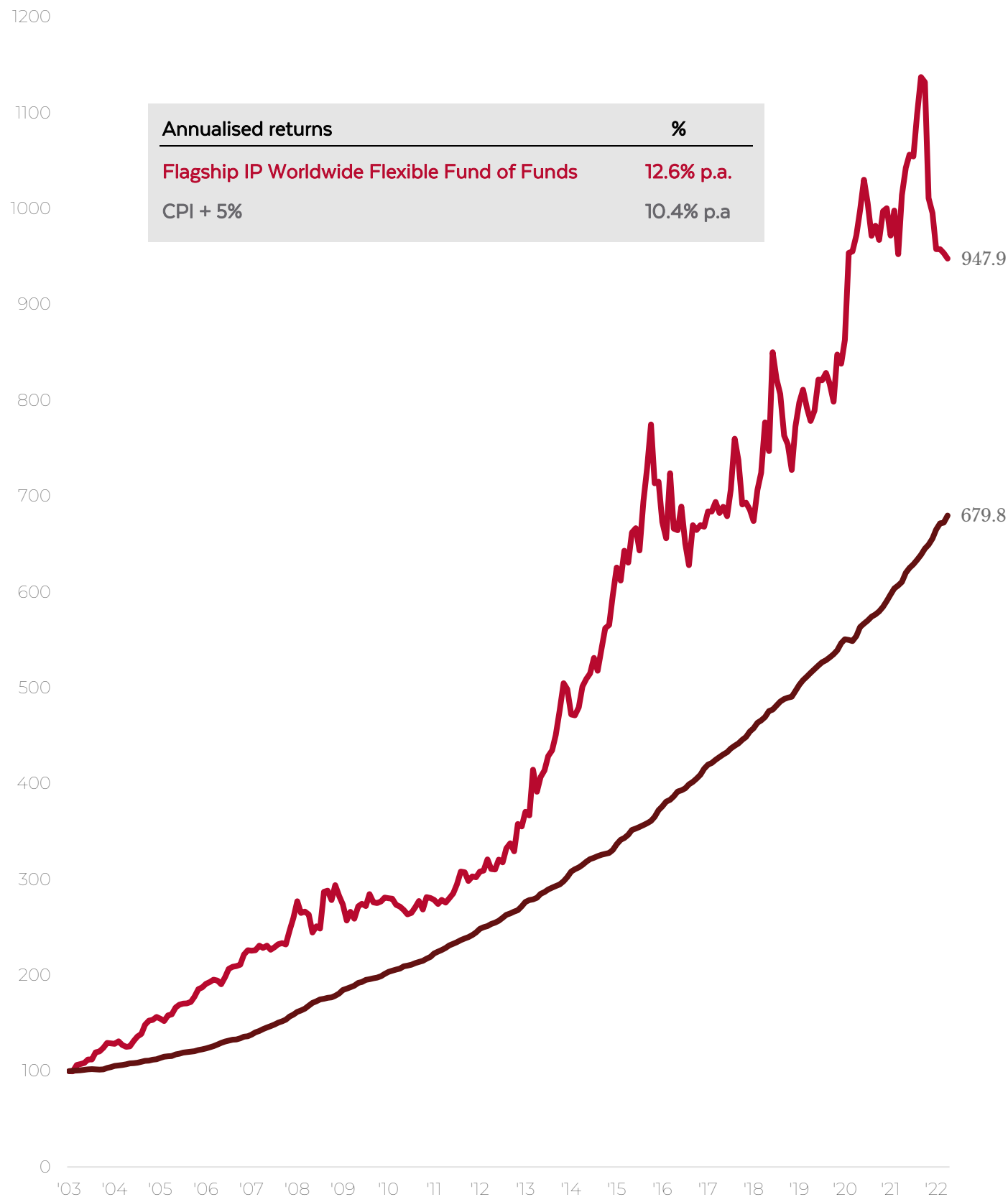
## JD Hayward (B.Eng.)

JD is an equity analyst on the global team at Flagship. Prior to Flagship he worked as an engineer and also spent 2 years at an Edu-tech startup in Cape Town. JD graduated from Stellenbosch University with a B.Eng. (Civil) in 2016 and has passed all three levels of the CFA exam.



# The Power of Long-term Compounding

The **Flagship IP Worldwide Flexible Fund of Funds** (net of all fees) vs. SA CPI +5%  
from 3 April 2003 to 30 June 2022 (19 years, 3 months)



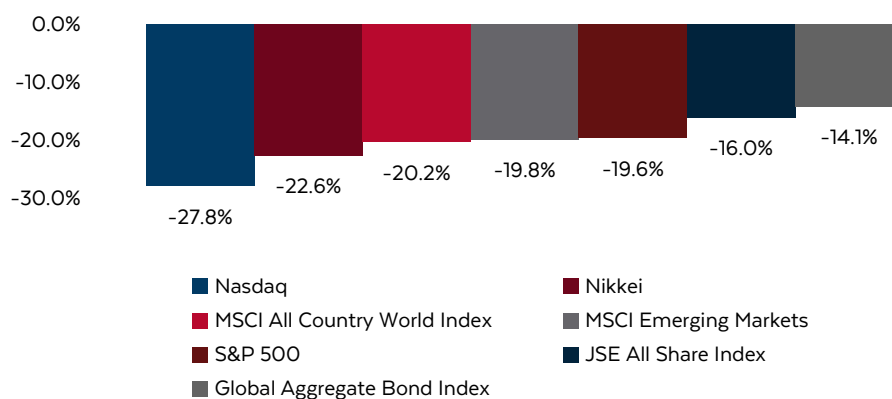


# Inflation on the rise

"Everything that needs to be said has already been said. But, since no one was listening, everything must be said again."

-André Gide

**Chart 1:** Global Index returns in USD (Dec 31, 2021 to July 14, 2022)

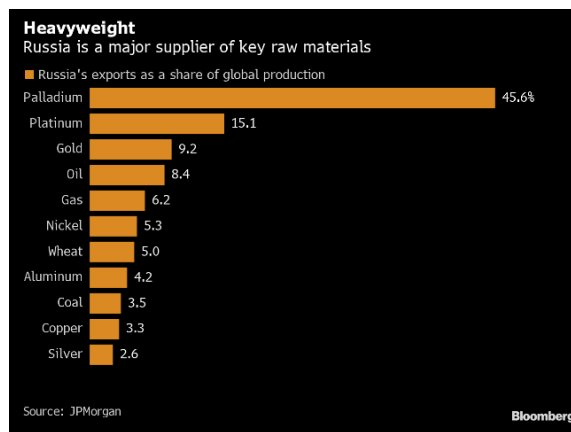
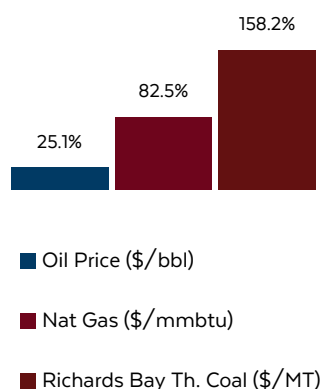


Equities are firmly in a bear market, suffering a decline of more than 20% from their peak in January this year. The reasons for the decline are well known: stubbornly high inflation, stoked by supply shortages, strong consumer demand and rising energy prices, is leading central banks around the world to tighten monetary conditions. As interest rates rise and global liquidity dries up, the fear of a global recession looms.

Market anxiety continues to drive equities in turbulent whip-saw motions. Pricey growth stocks, such as Netflix, Spotify, SEA, Shopify, Uber, SNAP, Zoom, Robinhood and Coinbase, (to which the Flagship portfolios have no exposure to) have seen their share prices collapse more than 65% on aggregate. However, even solid, profitable businesses like Facebook and Amazon have fallen 30% and 50% respectively in the year-to-date.

Sectors that have been resilient this year (such as energy and traditional defensives like consumer staples) have recently begun pulling back as fears of recession overwhelm otherwise strong price fundamentals. Despite the recent pull back, we believe the impact of the Ukrainian conflict, and the associated boycotting of Russian commodities, will continue to impact commodity prices for some time.

**Chart 2:** Global energy prices (YTD to July 14, 2022) & Russian % of key raw materials



As interest rates rise and global liquidity dries up, the fear of a global recession looms. Market anxiety continues to drive equities up and down.



Usually when stocks fall, bonds perform well, as investors rush for safety. However, due to rising interest rates, bond prices have also fallen significantly, with the global government bond index falling 14% year-to-date.

The global economy remains strong, with US GDP growth of 3.5% in Q1, and is forecast to expand 2.2% in Q2. Unemployment is at 3.6%, which is a multi-decade low. Consumer surveys tell a starkly different story, with the University of Michigan's Index of Consumer Expectations at 30-year lows. Clearly consumers don't see the good times lasting.

**Chart 3:** The University of Michigan's Index of Consumer Expectations to June 30, 2022

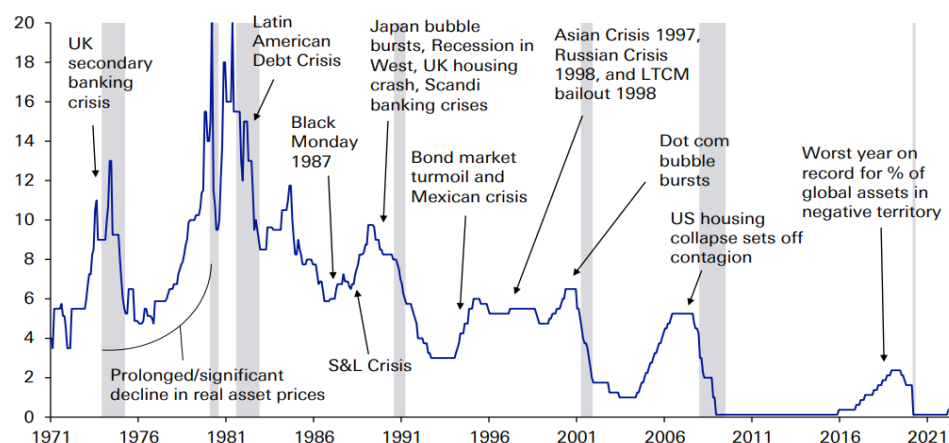


Note: The University of Michigan's Index of Consumer Expectations focuses on three areas: how consumers view prospects for their own financial situation, how they view prospects for the general economy over the near term, and their view of prospects for the economy over the long term.

History teaches us  
that, most of the time,  
rising interest rates  
lead to recessions.

Investors seem to be toying with the idea that the Fed can both tame inflation and avoid a recession, but this seems highly unlikely to us in light of historical precedent. History teaches us that, most of the time, rising interest rates lead to recessions. The chart below from Deutsche Bank captures this relationship quite nicely.

**Chart 4:** The Federal Funds rate from 1970, annotated by crises and recessions (grey shaded bars)



Source: Bloomberg Finance LP, Haver Analytics, Deutsche Bank

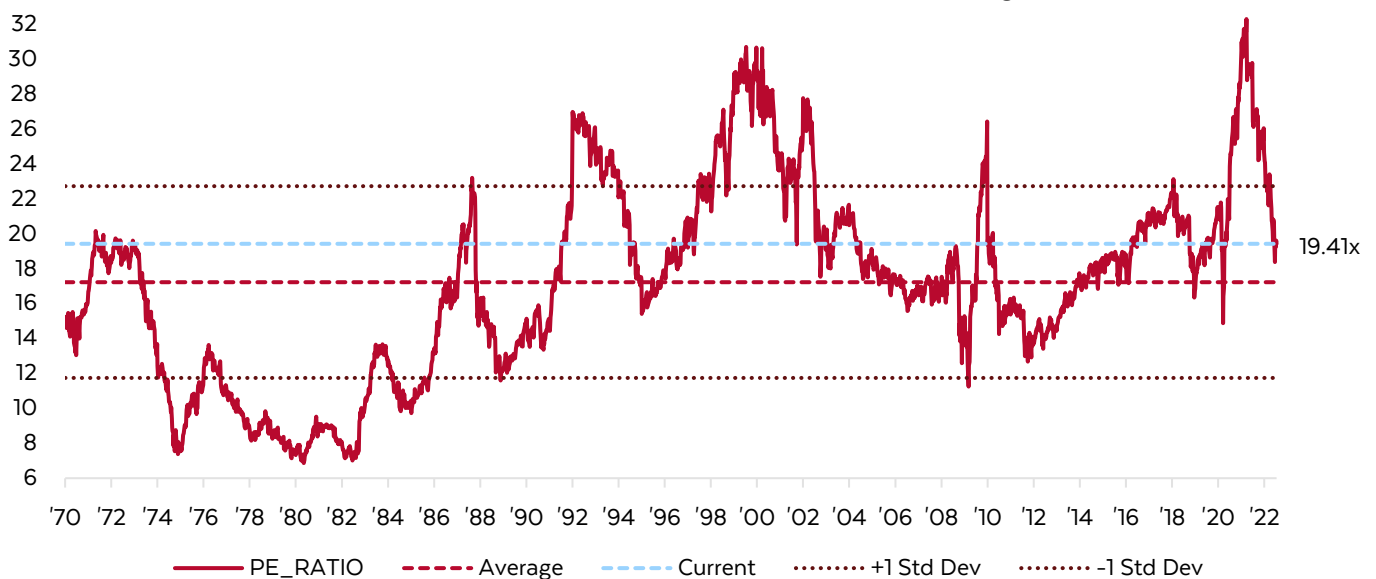


## Interest rate increases and recessions have two effects on equity investments.

The first effect is that higher interest rates depress the valuation placed on stocks. Much of this is mathematical: as interest rates increase, the value of long-dated opportunities falls. The second effect is through the fundamentals of each specific stock (i.e., the revenue and profits of the business) which can be adversely affected by a recession.

Looking at the first effect, stock markets are anticipating dramatically higher interest rates. The valuations of stocks, measured by the price-earnings (P/E) ratio, have seen one of the swiftest plunges in the history of the S&P500, with a retracement from 24.6x in January to 19.4x (-21%) by the end of June.

**Chart 4:** S&P 500 P/E Ratio History, Current & Average to July 14, 2022



Our shares have not been spared from this contraction in their P/E multiples. The shares we hold in Zalando, PagSeguro and Duck Creek, all fast-growing challengers in their respective sectors, have seen their P/E multiples retrace by over 50% over the past 7 months. Other portfolio stocks have seen their P/E multiples decline between 10% - 40%. Put simply, the higher the PE at the start of the year, the more this multiple contraction has impacted the share.

This has little to do with the quality of the business, and everything to do with the time-horizon that the business case captures in its share price. Whereas investors have in the past been willing to take long-term views on great business cases (such as Zalando, Take-Two interactive, Applied Materials and PagSeguro), these time horizons have now shrunk (note that the opportunities have not shrunk in our view).

Turning to the fundamentals, the strength of the businesses we invest in lead us to believe that their performance through a recession will be very good. Why do we say this? For a number of reasons:

- The first is their profitability. More profitable companies are able to manage their costs more effectively than lower quality companies. Higher gross margins are typically evidence of pricing power or scale advantages.

This has little to do with the quality of the business, and everything to do with the time-horizon that the business case captures in its share price.





- The second is their return on equity. Good companies generate high returns on equity, rewarding their investors through higher share prices over time.
- The third is their leverage. Good companies do not rely on excessive leverage to run their businesses.

The table below shows the equity positions in our portfolios. The gross margins of all our stocks are above 40% besides four businesses. The average return on equity for our portfolio is 18.5%. Only three of our positions (Informa, IFF and ABI) have net Debt exceeding 2x their EBITDA.

Name	GM %	RoE %	Net Debt /EBITDA
CAPRI HOLDINGS	66.2	34.9	1.9x
DICK'S SPORTING GOODS	38.2	59.2	1.0x
SQUARE ENIX HOLDINGS CO	53.5	19.3	-2.4x
INFORMA	66.1	1.4%	3.2x
APPLIED MATERIALS	47.5	57.3	0.2x
SUNCOR ENERGY	60.9	16.7	1.0x
AMAZON.COM	42.1	18.0	1.0x
INTL FLAVORS & FRAGRANCES (IFF)	33.2	2.6	5.0x
TAKE-TWO INTERACTIVE	56.2	11.7	-3.1x
ULTRA CLEAN HOLDINGS	20.3	17.0	0.9x
SCHLUMBERGER	16.4	15.0	2.2x
PAGSEGURO DIGITAL	46.1	12.2	-0.4x
ADOBE	87.9	35.1	-0.1x
ANHEUSER-BUSCH INBEV (ABI)	57.5	6.8	4.3x
META PLATFORMS	80.3	29.1	-0.5x
ZALANDO	41.3	6.5	0.6x
UBISOFT ENTERTAINMENT	87.3	4.6	0.7x
DUCK CREEK TECHNOLOGIES	57.4	(1.6)	-25.4x
RAKUTEN GROUP	60.4	nm	nm
ALIBABA GROUP	36.8	5.8	-4.9x
<b>Average</b>	<b>52.8</b>	<b>18.5</b>	<b>&lt;1.0x</b>

**While valuations have contracted meaningfully, earnings expectations are still adjusting.**

The pain in stock markets so far has come largely from a contraction in the valuation placed on stocks (the P/E ratio). Soon, we believe earnings expectations for the broader market will begin to decline.

For the reasons stated above on profitability, return on equity and leverage, we believe our businesses will not exhibit the same measure of earnings declines as the broader market.



If you missed even just the 10 best market days between 2002 and 2021, your total return was nearly cut in half, and seven of the 10 best days occurred within two weeks of the 10 worst days.

This is not to say that our businesses will not experience any earnings declines at all. AMAT and UCT for example, could see material declines in their volumes which must feed through to earnings. PagSeguro and our gaming businesses could continue to see cost growth ahead of inflation, and Dick's Sporting Goods and Capri could see impacts on their volumes which will hurt the bottom line. No stock is completely immune to a recession.

We believe however, that the valuations of our shares, *even in an environment where their earnings fall 20-30%*, is incredibly compelling. When adjusting for lower earnings in the next year or two, the share price moves continue to be driven by multiple compression and have little relation to the changes in the future prospects of the businesses that we own.

### Conclusion

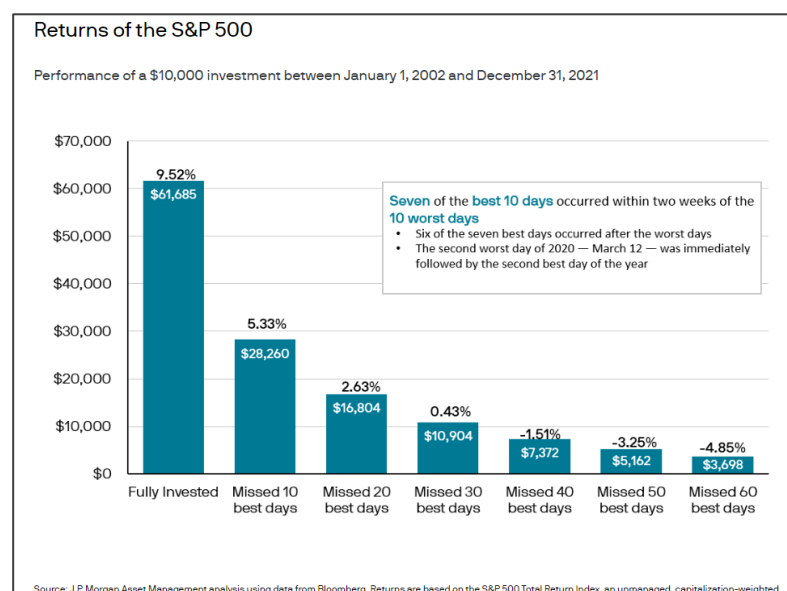
We realise that it may be cold comfort that the equity portfolios are well-positioned (in our view) considering that the Flagship equity portfolios have produced unrealized losses (negative alpha) since November 2021. Psychology teaches us that we feel losses more intensely than we perceive gains, and that affects our investing behaviour and our emotional journey through tough periods. With the vast bulk of Flagship's directors' and employees invested in the Funds, we feel every movement as keenly as you do.

In such an environment, it may be tempting for investors to believe their capital is safer in cash, value stocks, bonds or other alternative investments. Despite this tempting fiction, history shows us that even with drawdowns, equities remain the best asset to traverse rising inflation and recession. While investments in commodities (oil, gold and others) can alleviate some of the drawdown, their long term returns are poor in comparison to equities.

The belief of timing the market is also strong in this environment. This is a difficult science to get right, and I've rarely met anyone with the ability to do so. Investors may be tempted to take control in a way that is likely to be detrimental, selling out of the market after a significant drawdown – and locking in losses – with a plan to re-enter when things feel “safer”.

Research is also telling on the risk associated to this approach. J.P. Morgan Asset Management found that if you missed even just the 10 best market days between 2002 and 2021, your total return was nearly cut in half, and seven of the 10 best days occurred within two weeks of the 10 worst days.

**Chart 5:** Performance of \$10,000 between 2002 and 2021





# Performance & Equity Portfolio Changes

Performance across the Flexible and Equity Strategies remains challenged. The equity portfolio, which is reflected across both strategies, has been underperforming since November 2021 (nearly 9 months). While sporadic periods of underperformance are to be expected, we acknowledge they are psychologically challenging.

Fund	Q2 '22	%Δ YTD	%Δ 1YR
Flagship IP Worldwide Flexible Fund of Funds (ZAR)	-1.0%	-16.3%	-6.5%
Benchmark	2.2%	5.3%	10.8%
Flagship IP Worldwide Flexible Fund (ZAR)	-6.0%	-27.7%	-27.6%
Benchmark	-5.2%	-9.3%	1.6%
Flagship International Flexible Fund (USD)	-16.5%	-29.6%	-36.8%
Benchmark	-10.9%	-15.0%	-12.5%
Flagship IP Global Icon Feeder Fund (ZAR)	-13.6%	-35.7%	-36.7%
Benchmark	-6.0%	-18.8%	-3.9%

Year to date the largest contributors have been Suncor, Antofagasta and Booking Holdings. The largest detractors have been Zalando, Pageseguro and Meta Platforms.

During the first quarter we exited **Microsoft**, **PayPal**, **Karoo0000** and **Agesa**.

**Microsoft** has been a stalwart in the portfolio since June 2019. There has been no impairment to the business, but the valuation has run ahead of itself, in our view. The revenue growth over the past few years will struggle to keep pace with the growth in fixed costs that the business experienced over the good years. As this is rectified, we see attractive opportunities to re-enter the share in the future.

**PayPal** has experienced increasing competition for a number of quarters. While we were initially willing to give the Company the benefit of the doubt in terms of its competitive positioning, further research into the payments space (and meeting with key competitor Adyen in Amsterdam) has increased concerns around the opportunity set available to PayPal. We see decreased upside in our valuation, and hence have exited the position in favor of positions where we see more upside.

**Karoo0000** has been a contributor to fund performance since 2019. We believe the prospects are strong for the business, but have concerns around the inability of the Company to diversify away from South Africa. We also see a macroeconomic slowdown in South Africa which Karoo0000 will not be immune to.

**Agesa** was one of the stocks that offered the best long-term structural growth prospects in the portfolio due to how underpenetrated life insurance was in Turkey. Despite macro-economic troubles in Turkey, it was growing at double digits in real terms, traded on single digit earnings multiples and a high single digit dividend yield. It was, however, a Turkish company and we have become less sanguine about political risks given the events of the last year

During the second quarter we added **Anheuser Busch Inbev**, the world's largest beer company, and took broad Healthcare exposure via a Healthcare ETF.

## OUT

Microsoft  
PayPal  
Karoo0000  
Agesa

## IN

ABI  
Healthcare ETF



# Six Facts about Bear Markets

By Pieter Hundersmarck

If you invest with a long time horizon, you should expect – and be prepared – to face rough markets. Bear markets come around historically every 3.5 years. They are psychologically tough. They are always emotionally challenging. However, throughout history they have been relatively short-lived. Here are seven facts about bear markets which place them into perspective.

1. **They are common.** There have been 26 bear markets in the S&P 500 Index since 1928. And there have been 27 bull markets over the same period. Despite the deeply uncomfortable psychological impact that they have, they have always served as opportunities for long-term investors to get in to the market more cheaply than in a bull market.
2. **They are short.** The average length of a bear market is 290 days, or about 9.5 months, which is far shorter than the average length of a bull market, which is nearly 3 years. Some bear markets have lasted over a year however.
3. **They can be severe.** Drawdowns in a bear market are between 30-40% on average. The current bear market is near 22% down, although it is impossible to know if this bear market will end up on the lower or higher end of the average.
4. **They are psychologically challenging.** Investors feel losses more intensely than they perceive gains. This affects our investing behaviour and our psychological journey through tough periods.
5. **It pays to stay put.** The worst thing to do now is hop from stock to stock, or fund to fund. There is always a cycle, and it's your time horizon that determines your returns. As a cautionary tale, half of the market's strongest days in the last 20 years occurred during a bear market. Another 34% of the market's best days occurred in the first two months of a bull market – before it was clear that a new bull market was underway.
6. **Despite the emotional roller coaster, remember that markets tend to rise over time.** Over the last 100 years, bear markets made up only a fifth of those years. Put differently, for most of the last century, stocks have been on the rise c.80% of the time. Often investors miss out on the market's overall gains because they try to time getting in and out of the market, missing the most important days.

While declining values can be difficult to stomach, it's important to keep in mind that market downturns have always been a part of the investment process. Few can consistently predict when down markets are going to occur, and investors should always be appropriately placed to deal with them.

Most importantly, investors must understand that bear markets have *always* been opportunities to build wealth. While share price declines seem negative, they are in fact enormous opportunities for those with a long-term time horizon.

Investors must understand that bear markets have always been opportunities to build wealth. While share price declines seem negative, they are in fact enormous opportunities for those with a long-term time horizon.



# Are REITs the best place to hide in a 1970s inflation scenario?

By Kyle Wales

**The experience during the 1970s** might suggest that the risk of an outlier scenario of persistent high inflation may be greater than what many think. In the words of Mark Twain “History doesn’t often repeat itself but it often rhymes”.

I will look at which asset classes provided the best protection during that period and which asset classes might provide the best protection today, should this type of outlier scenario materialize.

## Similarities with the 1970s are troubling

Unfortunately, rather than allaying one’s fears, any comparison of the situation today with the 1970s provides additional cause for concern.

Firstly, the decade of the 1970s began with monetary debasement, which draws an obvious parallel with the era of easy money that has followed the Global Financial Crisis (GFC). Secondly, the high inflation experienced during that period was also made worse by two exogenous shocks, similar to the two shocks – re-emergence from Covid, the Ukraine crisis – that have contributed to the situation today.

Looking back, the stage for the stagflation of the 1970’s was set at the beginning of that decade with the “Nixon Shock”. This refers to the announcement made by Nixon on the 15th of August 1971 when he announced a combination of wage and price freezes, import surcharges and, most importantly, suspended the convertibility of the dollar into gold with immediate effect.

This action dismantled the Bretton Woods fixed exchange rate system. In terms of that system the US dollar was pegged to (and redeemable) in gold at a fixed price of USD 35 per ounce and all other currencies were pegged to the dollar.

Bretton Woods had served the world well but the fiscal imprudence of the US during the 1960s (partly to finance the Vietnam war), as well as its negative balance of payments ultimately made it unviable because the US gold reserves became insufficient to cover its dollar liabilities. Because of this, some of the US’s trading partners began requesting redemption of their dollars for gold and this posed a risk that there would be a run on the US’s gold reserves.

It was not just the Nixon Shock which contributed to the high inflation of the 1970’s, however. The situation was worsened by two oil crises during that decade.

The first of these, in 1973, was caused by OPEC countries embargoing countries which supported Israel during the Yom Kippur War. This saw the price of oil rise from US\$3 per barrel to US\$12 per barrel. The second, in 1979, was caused by the Iranian Revolution which removed Iran’s production from the oil market. This saw a doubling in the oil price from US\$20 per barrel (immediately prior to the crisis) to US\$40 per barrel.

Unfortunately, rather than allaying one’s fears, any comparison of the situation today with the 1970s provides additional cause for concern.





Instead of commodities and gold, certain types of REITs, specifically those with short duration leases, might be the asset class that performs the best.

Fast forward to today and the notion of a “hard” anchor for currencies has been absent for a while but it is hard not to wonder whether a currency debasement of another type, in this case the easy money era following the GFC, might pose a problem. This view gains further credence if we look at the popularity of cryptocurrencies like Bitcoin whose adherents take a lot of comfort from the fact there is a fixed number of Bitcoins that may be issued and no monetary authority can issue them at will. As stated above, two exogenous shocks – re-emergence from Covid, the Ukraine crisis – have also contributed.

#### Which asset classes provide the best protection against outlier high inflation?

The chart below shows the returns provided by various asset classes under different inflation scenarios is a good place to start. I will, however, limit my discussion to that part of the chart which consists of inflation observations exceeding 5%. Most of these observations were recorded in the 1970s.

Since 1970	US equities total return, yoy	US bonds total return, yoy	US REITs, yoy	Real Estate Index, yoy	GSCI Commodity Index, yoy	Brent Oil, yoy	Gold, yoy
>5	5.19%	5.29%	9.41%	8%	20.10%	39.07%	21.39%
Ranking	7	6	4	5	3	1	2

Historically when inflation exceeds 5%, commodities have been the best performers (oil as well a broader commodity index take the first and second places respectively). They have been followed by gold in third place and then by US REITs in fourth place.

Interestingly, while both performed poorly, US bonds actually outperformed US equities which is not a result that many people would have expected. The reason for this is twofold: firstly, equities underperformed because very high rates of inflation are often accompanied by low economic growth rates (hence the term “stagflation”) and, secondly, they are long-duration (perpetual) assets, so equity valuations suffer as the result of a higher discount rate being applied to the longer stream of future cashflows they offer investors (the blended duration of a bond index is far lower than the effective duration of an equity index).

To what extent would we expect asset class returns to mirror the past if we experienced a period of outlier high inflation today? I believe that there is compelling argument to be made that instead of commodities and gold, certain types of REITs, specifically those with short duration leases, might be the asset class that performs the best. The reason for this is that both commodities as well as gold have very significant shortcomings which may be hard to overcome.

Let’s begin with the shortcomings of commodities. The cleanest way for portfolio investors to gain broad commodity exposure is through a collateralized futures ETF rather than an ETF which holds the various underlying commodities directly. Collateralized futures ETFs, like physically backed futures ETFs, carry an implicit charge for cost of storing the physical commodity (which can be high for certain high volume, low value commodities). They also carry a second charge, an implicit interest charge. This charge is to prevent cash-and-carry arbitrage between the futures and physical markets and could provide a very large offset as interest rates typically rise in tandem with inflation rates.



Gold also has its shortcomings. Unlike other commodities, the largest gold ETFs are physically backed. As I stated above, there is no implicit interest rate charges built into pricing of physical gold ETFs but there is a “negative carry” from holding gold which is the opportunity cost of holding an asset which doesn’t provide an income. This may impair its desirability as an inflation hedge. Secondly, while the role of gold as a store of value has been entrenched for centuries, there are a number of asset classes that are vying with it for this role today, amongst them Bitcoin. These asset classes may further impair its desirability as an inflation hedge.

REITs surmount all of these problems. Firstly, there is no implicit interest rate charge or negative carry that need to be recouped, only an opening yield which is typically set to grow in line with contractual, often CPI-linked, escalations. Property valuations also tend to rise with inflation, and, unlike gold, there are no storage costs.

Not all REITs are created equal, however, and it is those with short duration leases that will be better at passing on rising inflation.

While I expect inflation to be transient, the risks of the situation today evolving into scenario of persistent high inflation is far from zero. The 1970’s has concerning parallels with the situation today and once inflation takes hold, it is very hard to stop it in its tracks. The cycle of negative (high) inflation expectations becomes self-reinforcing.

I believe investors with multi-asset mandates should hold small positions in all asset classes that have proven themselves as inflation hedges, and specifically re-evaluate the role that REITs might play, as this might prove very valuable in a portfolio context.





## Investment Case: Suncor



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- ⇒ Suncor is a Canadian Oil Sands and Syncrude Business. With their substantial capital costs and oil-focused production mix, Canada's oil-sand producers are among the biggest beneficiaries of high crude prices.
  - ⇒ Between a global supply shock in the oil market and an increase in geopolitical tensions, Suncor, along with the rest of the North American energy sector, went from the back to the front burner.
  - ⇒ Suncor is effectively a capital management investment case: the cash flows they generate will be used to de-gear, pay down debt, and buy back shares. They are in a very secure jurisdiction (Canada) and have highly regarded management.
  - ⇒ The share trades on 4.9x 2023e earnings and a 4.7% dividend yield.
- 

Suncor's business operations can be divided into three main segments: Oil Sands, Exploration and Production, and Refining and Marketing.

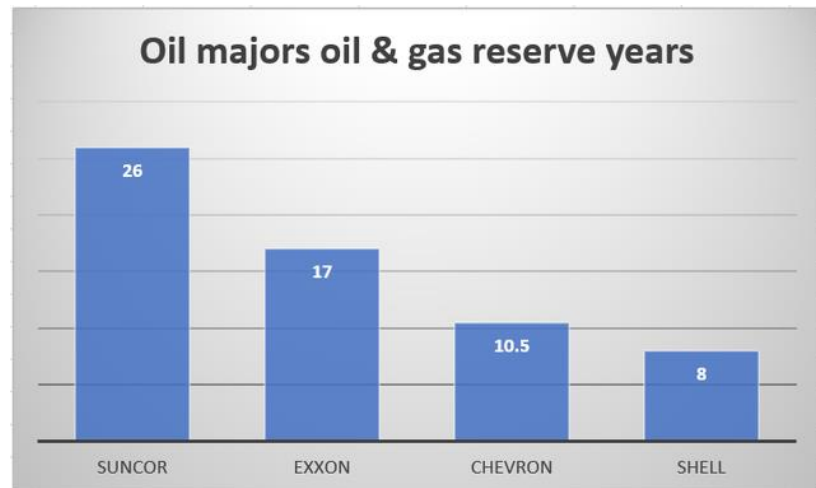
- Suncor's Oil Sands segment, with assets located in the Athabasca oil sands of northeast Alberta, produces bitumen from mining and in situ operations. Bitumen is either upgraded into hydrocarbons for refinery feedstock and diesel fuel, or blended with diluent for refinery feedstock or direct sale to market through the company's midstream infrastructure and its marketing activities.
- Suncor's E&P segment consists of offshore operations off the east coast of Canada and in the North Sea, the Norwegian Sea and other fringe areas.
- Suncor's Refining and Marketing segment consists of two primary operations: the Refining and Supply and Marketing operations discussed below, as well as the infrastructure supporting the marketing, supply and risk management of refined products, crude oil, natural gas, power and byproducts.

The bulk of revenue, and where the value in the operations sit, is with the Oil Sands Segment.



The first aspect that makes Suncor valuable is its long reserve life. As the chart below shows, the reserve life of Suncor far exceeds that of its well-known peers. This is an enormous advantage in a time when exploration and identification of reserves is becoming more costly and difficult. A high reserve life also provides meaningful visibility to the Company's discounted cash flows.

Chart 1: Suncor Reserve life versus peers



The second, less obvious reason is the utter lack of capex into oil exploration and production over the past 8 years

Secondly, the backdrop for crude oil is attractive. The price of oil bottomed in the spring of 2020 during the Covid-19 market crash, but today, a barrel of oil fetches over \$100 in the U.S. The Russia-Ukraine war has been one of the most obvious reasons behind the surge in oil prices. This situation has magnified the risk to the supply of oil, leading to a supply-demand imbalance coupled with the resurgence of geopolitical risks.

The second, less obvious, reason is the utter lack of capex into oil exploration and production over the past 8 years. Misguided ESG, and a misunderstanding of the timeline required to phase out dirtier fuels in favor of cleaner fuels, has led to a supply imbalance that the world is now slowly paying the consequences of. While this will ultimately self-correct (oil capex is once again on the rise) there is a meaningful lag that will keep oil prices above \$80 until new sources of supply are found, or demand shrinks drastically (which is not our base case).

Thirdly, the cost profile of Suncor is attractive. Suncor has worked hard to optimize its operations and can operate at breakeven, including its dividend payments, at approximately \$35 per barrel of oil. This provides a meaningful cushion when oil prices decline, and on the flip side offers substantial gearing to higher oil prices.

## Breakeven Sensitivities & Cost Management<sup>1,2,3</sup>

### AFFO<sup>4</sup> breakeven on \$USD WTI pricing

Assumes USD WTI/bbl

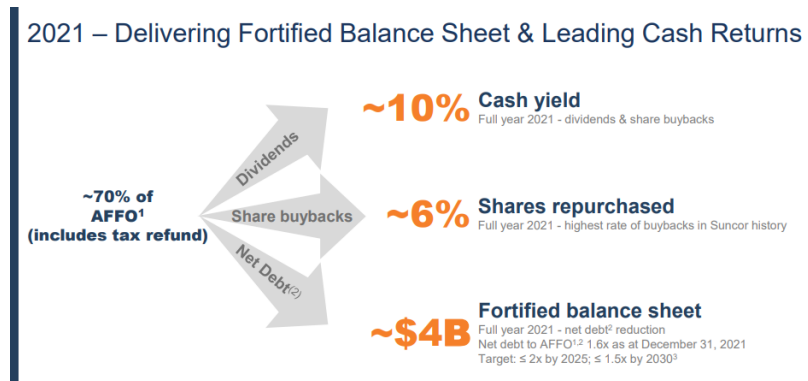
**~\$30/bbl WTI<sup>5</sup>**  
covers total enterprise  
operating costs  
+ sustaining capital<sup>6</sup>

**~\$35/bbl WTI<sup>5</sup>**  
covers total enterprise  
operating costs  
+ sustaining capital<sup>6</sup> + dividend



Additionally, the company returned nearly \$4 billion to shareholders in the form of dividends and share buybacks, and reduced its debt-to-equity position back to near 2019 levels.

Fourthly, the capital management is excellent. Suncor's management is among the most shareholder-friendly management teams you would find in the oil & gas industry. Management have identified clear areas where capital will be extended, shown in the graphic below:



After a tough 2020, due to improving conditions in the energy market, Suncor's 2021 was a major improvement. The company grew annual revenues YoY by 60% and grew its operating cash flow by over 300%. Additionally, the company returned nearly \$4 billion to shareholders in the form of dividends and share buybacks, and reduced its debt-to-equity position back to near 2019 levels.

In 2021, Suncor repurchased 6% of its shares at an average price of C\$27.45 per share. With the share price now above this figure, this turned out to be a good capital allocation strategy.

Starting January 2022, Suncor has stated that it will be repurchasing 5% of its shares over the next twelve months, with the intention of completing this program in January 2023. In practice, this means that with its current dividend yield of around 4%, investors are going to get at approximately 10% in capital returns in 2022.

Furthermore, based on its guidance and an even split of free cash flow between debt cuts and buybacks, Suncor could cut another C\$3.7 billion of debt (after trimming net debt by C\$3.7 billion in 2021). This would take their net debt to C\$12.5 billion, the low-end of the C\$12-C\$15 billion 2023 target they set themselves.

Finally, there is scope for activist investors to drive further incremental change at Suncor. Suncor has entered into an agreement with Elliott Management to appoint three new independent directors to the company's board and conduct a strategic review of its downstream retail business. Suncor could generate C\$9.6B-C\$11.2B in pre-tax cash proceeds and C\$7.7B-C\$8.9B in after-tax cash proceeds for its retail gas station network, according to Credit Suisse. Such a transaction would meaningfully improve the capital intensity of the business, while also increasing the scope for shareholder returns.

### Summary

Suncor fits neatly into our universe of ideas where the payoff is asymmetrical: the downside is limited by low costs of production and a positive long-term outlook for the oil price, while the upside is meaningful through improved capital management. We thus have a combination of external factors (oil price, growth in production) and internal factors (self help on costs, capital returns to shareholders) in our investment case. At less than 5x earnings and over 4% dividend yield, we believe the risk reward is heavily skewed in our favor.





## In conclusion

We write these Telescopes so that our investors know what it is we are doing, and why we are doing it. For many of you, we are the caretakers of a large portion of your global investments, and 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.

We believe it is of the utmost importance that all clients feel a true sense of the word “Partnership” in how we are aligned. Our portfolio management team reflects this with significant personal investments in the Flagship strategies.

Flagship funds own a selection of businesses that we believe to be of unusually high quality, and will prove to be financially resilient whatever the prospects of the global economy.

We expect the value of these businesses to rise at an attractive rate over the coming years, and that owning these businesses at a discount to what they are worth will make an additional contribution to your returns.

While we believe that Flagship funds will continue to outperform over longer-term periods, there will inevitably be shorter-term periods over which our funds will not outperform. This is the nature of markets – one’s alpha (or excess performance relative to one’s benchmark) is lumpy and doesn’t accrue in a straight line.

*Warm Regards,*

Pieter, Kyle and the Flagship Global Team







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