Robert Cowen Investments

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Newsletter

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The Family Office

You are welcome to pass this newsletter on to friends who may wish to learn more about investment.
To be added to our email, contact alan@rcinv.co.za

"If everybody is thinking alike, then somebody isn't thinking."
~ George S. Patton Jr.

RCI MET Flexible Fund – closed June at 381.20, 0.83% down for the month and 1.72% lower than 12 months ago. The JSE Top 40 fell 0.13% for the month and is down 1.38% versus a year ago. Despite this inconsequential 12 months, we are still up 11.5% per annum over the past three years where we ranked 21st out of 76 funds. So why this minimal under performance over the past year? We have been surprised by the strength of the rand over the past six months. Metal prices have improved a bit (but we don't think they can last) and Mr. Pravin Gordhan has been doing a sterling job in holding back the downgrade by the international rating agencies.

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Brexit effects.

Downgrade still likely in December – we await rand weakness but in case we are wrong, we want our local shares to pay high and sustainable dividends.

Visit our website: www.rcinv.co.za for back copies of the newsletter, background information, etc.

Please take note:

- Financial Statements for Trust Accounts should be available by the end of August.
- Please cc Michelle@rcinv.co.za on any request for payments. It can take up to 2-3 days for payments (as funds often have to be recalled from PSG). If we have to sell shares first it takes up to 4 days.

Shale oil cost is right down to below $50. A $100 oil price seems remote.

Foreign flows were negative, not positive on SA shares. "Sorry" says JSE.

The municipal elections? What will change?

Break out, top or both? Food for thought from UBS.

Why are we buying Gilead? A pharmaceutical company supplying Hepatitis C and HIV drugs, it meets our ROCE and free cash flow requirements, despite the outlook for declining sales.

Our portfolio is set up for a 75% probability of rand weakness and a possible downgrade

We have been surprised by the strength of the rand over the past six months. Metal prices have improved a bit (but we don't think they can last) and Mr. Pravin Gordhan has been doing a sterling job in holding back the downgrade by the international rating agencies. The elections have gone off with a low level of political violence. Some people believe that the ANC might recall President Zuma after the ANC's loss of the majority in Johannesburg, Port Elizabeth and Pretoria. This, they reason, is likely to cause the rand to strengthen further. We do not put a high probability on this – it is much more likely that we will continue to muddle on, both in terms of our president and our economy.

Brexit caused a massive drop in the pound and uncertainty over the future of the Euro. The rest of the world is in a heck of mess which makes South Africa seem not so bad by comparison and some foreign money has flowed into our gilts. The SA Breweries deal is to go ahead (probably by the end of September) which is holding up the rand for now. Once that is out of the way, investors' eyes will start turning towards the potential downgrade which might occur in December. Thus we are investing the bulk of our funds on the following scenario: The world metal oversupply will take years to unwind, the upward blip in metal prices is temporary, company profits will be low, tax collected will disappoint putting pressure on government deficits. This will result in low increases in government salaries and social grants.

SA's downgrade will come sooner or later, the currency will weaken to worse than R16 to the dollar so rand hedges will then perform relatively well. The only two bright spots we expect for the economy are tourism and agriculture (because the drought should break). Thus we have positioned our portfolio into lots of rand hedges that should perform well if the rand is weak. Over the past six months, the rand and the economy has been stronger than we expected but 'the centre cannot hold' and sooner, rather than later, rand weakness is likely to resume. When that happens, our portfolio will perform relatively well, at least when measured in rand terms.

The oil price required for Shale Oil to breakeven has fallen to $48 and, in some cases, only $39

Extracts from a Fuller Treacy Money article of 19th July 2016

US shale is lowest cost oil prospect

By Ed Crooks from the Financial Times which may be of interest.

US shale regions that two years ago were in the middle of the cost curve for future oil supplies are now down towards the lower end

Investments in the Eagle Ford shale of south Texas on average need a Brent crude price of $48 a barrel to break even, on Wood Mackenzie's calculations, while projects in the Wolfcamp formation in the Permian Basin in west Texas need $39.

Brent was trading at $47.59 per barrel on Wednesday.

The number of large projects being given the go ahead by oil and gas companies averaged 40 a year between 2007 and 2013 but dropped to just eight last year, according to Angus Rodger, also of Wood Mackenzie.

Editor: The dramatic fall in the cost of fracking to $39 and $48 dollars implies that oil is not going back up to $100 any time soon.

Foreign flows – "Sorry about the mistake!" says the JSE

On the 18th of July it was reported that the JSE said South Africa had had record inflows of R65bn into our shares from foreigners in June alone. A record 35 days in a row of inflows was reported!

We had been intrigued by these reports of big inflows into our shares – the currency strength was then understandable. What worried us was that a large inflow was coming in so casually, so it could just as easily flow out again.

A few days later, the JSE owned up to a mistake in their computer programme – there had actually been outflows from our shares but some inflow into our gilts. We were not sure whether to be glad or sad! At least there is not a lot of hot money looking to flow out again if the rand weakens! We might be pessimistic about South Africa's economy and the rand but we take no joy in the problems facing the country over the next few years. We would love to be proved wrong! But that is not, in our view, the way to bet.

The Municipal Elections – what will it change?

"Politics is the gentle art of getting votes from the poor and campaign funds from the rich, by promising to protect each from the other." *~Oscar Am ringer, "the Mark Twain of American Socialism."*

"Instead of giving a politician the keys to the city, it might be better to change the locks." *~Doug Larson (English middle-distance runner who won gold medals at the 1924 Olympic Games in Paris, 1902-1981)*

"We hang petty thieves and appoint the bigger thieves to public office." *~Aesop, Greek slave & fable author*

"Those who are too smart to engage in politics are punished by being governed by those who are dumber." *~Plato, ancient Greek Philosopher*

"When I was a boy I was told that anybody could become PM; I'm beginning to believe it." *~Quoted in 'Clarence Darrow for the Defense' by Irving Stone.*

The trouble with getting old and cynical is that one has seen it all before. The new promises of politicians remind one of the previous promises that were never kept. However, hope springs eternal that maybe this time will be different.

So now we are going to have horse-trading over who will run Johannesburg, Pretoria and Port Elizabeth. Will it make a big difference to its citizens? Has the DA running Cape Town made such a difference? Of course one might argue that clean streets and rubbish collection are 'very nice' but is the course of our lives changed by such decisions? One might argue that it is a start and that 'big oaks from little acorns grow'. The best thing about being a pessimist is that you score when you lose!

We will be surprised if these elections make any substantial difference in the short term but if this portends similar results in the country wide elections, proper change might happen. The results of coalition negotiations over the next week or so are going to be the real determinants of the possibility of meaningful change.

The Americans are threatening change with the possible election of Donald Trump. Is this simply the electorate voicing their discontent with getting poorer over the past 40 years? Are Trump's policies going to make it better or worse? The electorate seem to be saying, we don't care, we just want change – and we hope it will be better!"

So what should investors do? It is crucial to try to see things as they really are – not as you want them to be!

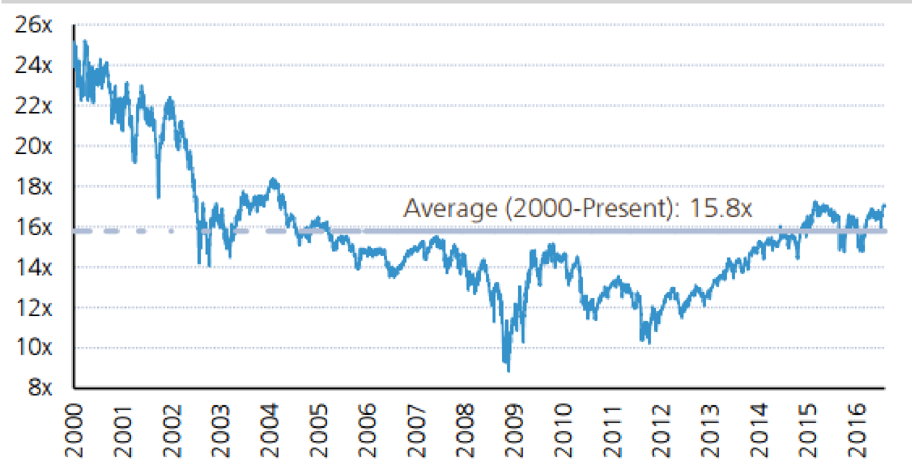
We should work out the probabilities of each outcome and weight our bets accordingly.

Breakout, top or both?

A UBS report posed an interesting conundrum. Using their $119 estimated earnings for 2016 results in an 18.2x PE, which is the highest level since the Tech bubble burst, one might argue that the PSE is too high considering the very low expected growth rate. Alternatively, one can argue that the earnings are fine compared to the alternative of earning very low interest on bank deposits. Consider that earning a 2.5% dividend on most quality shares is much better than earning zero interest. With very small and slow increases in interest rates expected for many years, shares seem the LEAST WORST ALTERNATIVE. If the US shares fall, we expect the rand and the JSE to fall even further, and in the meantime, if you are in safe American shares, the dividend stream should continue.

At 18.2x our $119 UBSe for 2016 earnings and around 17.5x NTM, S&P 500 valuation is as now as high as it has been since the end of the Tech bubble burst in 2002 (Figure 2).

Figure 2: S&P 500 Forward PE



Source: FactSet, UBS

Gilead Sciences - a recent addition to our offshore holdings

Gilead is a pharmaceutical company that makes 65% of its money from Hepatitis C drugs and the balance from HIV drugs. We asked our analyst to prepare a summary of why we recently bought some and his "simple" analysis follows below. Asking a 'rocket scientist' to write 'simply' proved to be somewhat of a waste of breath, so let us summarise the article in two paragraphs, then you can decide if you want to wade through the rest of his article.

Gilead was making a huge amount of profit from selling HIV drugs to America and the rest of the world. It used this large cash flow to purchase a Hepatitis C drug which turned into another winner. This drugs CURES Hep C so a lot of patients waited to get it, even though it costs $80 000 for the course. Thus sales were through the roof from October 2014. Now, as the number of patients with Hep C, and who can afford to pay for it, drops each quarter, the profit will have peaked. So what are they going to do with the huge, but declining, profit stream? Firstly, they will pay dividends, secondly, buy back their shares (so earnings per share will grow) and thirdly, they will look for the next winner to buy.

Because growth will slow as the patients are cured and the number of patients who can afford it diminishes, growth will not be fantastic but they should be able to use the strong cash flow to buy back shares and support the share price. We believe they will give us a very high ROCE (return on capital employed) and high free cash flow. The price has collapsed to the extent that we think it is going to earn our clients a very good, low risk return.

This is what our analyst has to say:

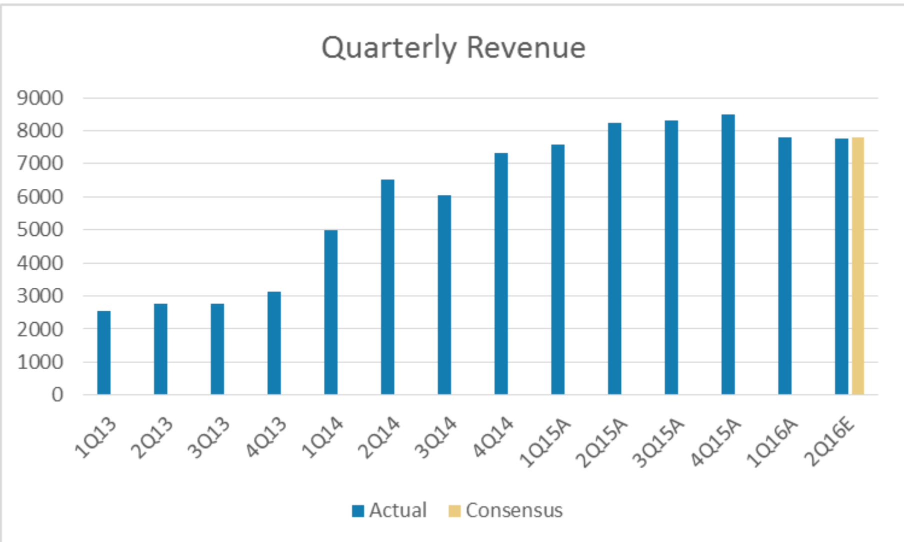
Gilead Sciences is a biopharmaceutical company that discovers, develops and commercializes innovative therapeutics with specific focus on antivirals. The company has been around for over twenty years where it has been the market leader in HIV medication. It bought the cure for Hepatitis C in 2011 from another biotech and began selling this blockbuster drug in 2013.

The market is mostly concerned that Gilead does not have a sufficiently diversified drug portfolio as the majority of its revenue comes from two HIV drugs and two Hep C drugs. We have been buying Gilead of late but the market has knocked it down to incredibly low levels as they are mostly concerned about the decreased revenues of Hepatitis C in the USA. This is mostly because when the drug was first released it was an explosive success as you can see from the below graph (Jump in 1st Quarter 2014) as the first patients were waiting years for the cure and the short term demand was not a long term indication of the drug's success.

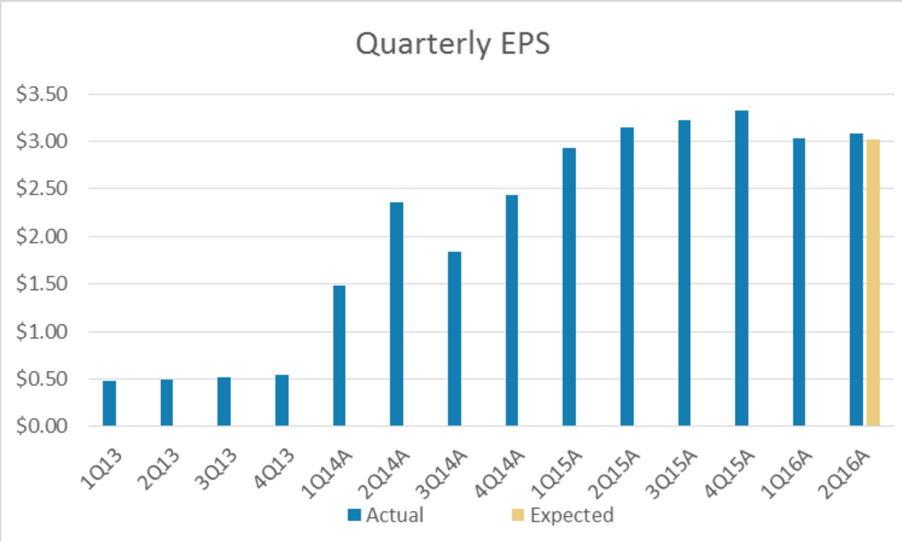
Key points:

- Gilead has a market cap of over $110 billion and a $32 billion revenue stream for the 2015 financial year.
- About 85% of revenues come from four drugs.
- HIV drugs are Truvada and Atripla, with a new drug called Genvoya. Increased competition from GSK. HIV makes up about one third of Revenue.
- HEP C drugs are Sovaldi and Harvoni. Increased competition from ABBVIE. Hepatitis and others make up the other two thirds of revenues.
- There are about 170 million people with chronic Hepatitis C.
- 2.5% dividend yield.

Gilead reported results this month posting a revenue figure of $7.78bn vs consensus expectations of $7.799bn. This number was virtually flat for the quarter (compared to Q1 2016) but down 5.7% for the year (since Q2 2015).

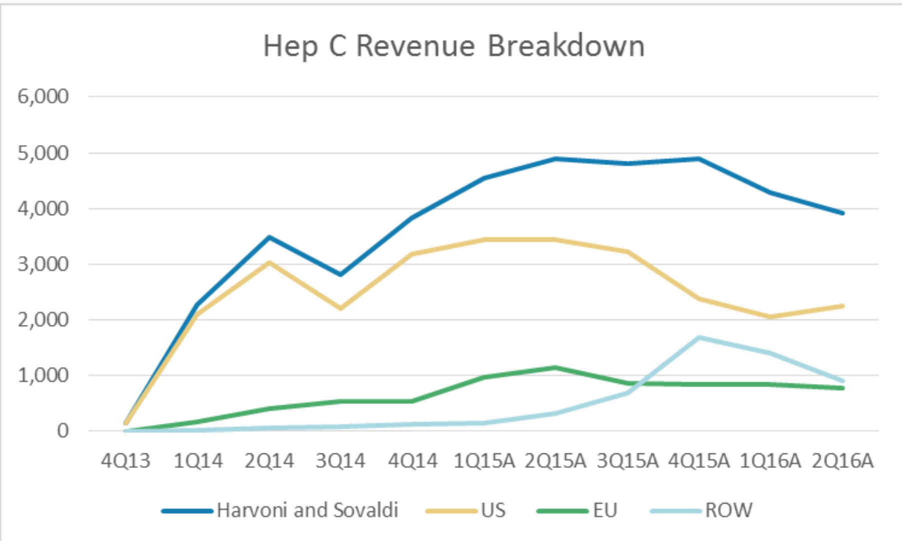


Earnings per share came in at $3.08 beating consensus of $3.02. This is an increase of 1.7% on the previous quarter and a decline of 2.1% YOY (Year on Year).



We highlight that the market seems to focus almost entirely on the Hepatitis C revenues which did not beat consensus expectations. Thus, despite Gilead's total revenue being very much in line with expectations and EPS beating consensus forecasts, the market continues to punish the share.

In our view, part of the problem is that Gilead is the victim of its own success as the Harvoni and Sovaldi Hepatitis C drugs resulted in a revenue and EPS explosion as many patients were waiting years for the treatment to come online. So when these drugs were finally released it was an over representation of the demand resulting in recent sales for these products coming off of an extremely high base. Therefore, we note that even though revenue in the Hepatitis C drugs is coming down YOY, it is not a long-term reflection of the disease itself. In the chart below we highlight Gilead's Hepatitis C drugs revenue breakdown:



The blue line shows the total revenue from Harvoni and Sovaldi which has decreased 8.6% for the quarter but 19% down YOY. This is the data that is spooking the market. What is interesting to note is the orange line showing the USA sales (which are about 60% of sales) has risen 9.6% for the quarter but is still down 34% YOY. This at least shows stability in the short term.

One thing that is of concern is the decline in sales from the Rest of World which the market needs to replace the sales from the USA who are rapidly healing chronic patients. Hep C in the USA is currently declining about 13% per year and we are of the view that the ROW still needs time to properly take up this drug which should then hopefully see ROW sales bottom out and then grow. The caveat, in our view, is the threat of generics.

HIV:

Gilead is the top seller of HIV medications with a 75% market share in the USA and 50% market share in the world. HIV grows at about 5% per year in the world but only 1% in USA. Their older drug regime were front run by Truvada and Atripla.

	2Q2015	2Q2016	
Truvada	849	942	
Atripla	782	673	
Old Drugs Total	**1631**	**1615**	
		-0.98%	
Genvoya		302	(New Replacement Drug = one a day tablet)
Grand Total	**1,631**	**1,917**	
		17.54%	

Truvada and Atripla have declined by 1% for the year but these drugs have been replaced by a new one-pill-a-day Genvoya. So if you consolidate the revenue we see a YOY growth of 17%. But long term growth rates are more in the range of 5%. This short term spike will settle.

A couple of salient points:

- Still no M&A announcement that would match the excitement of the Pharmasset deal (the purchase of Sovaldi).
- Cash is currently $24.6 billion of the $117 billion market. They thus have a large amount of ammo to buy another company or pay out dividends or buyback their own shares.
- Gilead announced they will increase their expenditure on R&D going forward with specific focus on Hepatitis B.
- Gilead reduced the number of shares by 9% over the past year! This equates to about 11 million shares per month. And at the current price of about $86, they were retiring a whopping $900 million worth per month.

Back-of-the-matchbox valuation calculation for Gilead

	2016 EPS	12.32			
				PE	Price
	HIV	4.11	(1/3)	12	49.28
	Current Market value			7.2	85.1
Implied:	Hep C and other	8.21	(2/3)	4.36	35.82

HIV division is about one third of company and has growth of about 5% over the long term. Give this a conservative PE of around 12 which is in line with what it was before Hep C cure came about gives it a market price of about $50. The current price is $85 dollars. The whole company has a PE of about 7.2. Therefore the other two thirds of the business including Hep C is valued at about a 4.3 PE. So the market is very pessimistic on their future of this business.

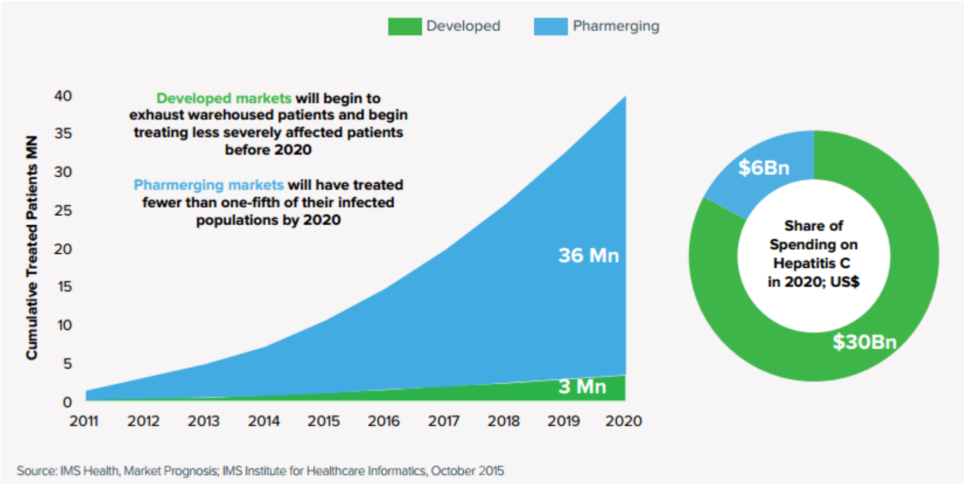
Also the cash makes up about 20% of the market cap so you could reduce all of the above PE figures by 20% showing an even more attractive investment case and a lot of room for error.

We believe the valuation of the business should be closer to a 9 PE and consequently the upside for Gilead is around 25% excluding a 2.5% dividend.

Conclusion:

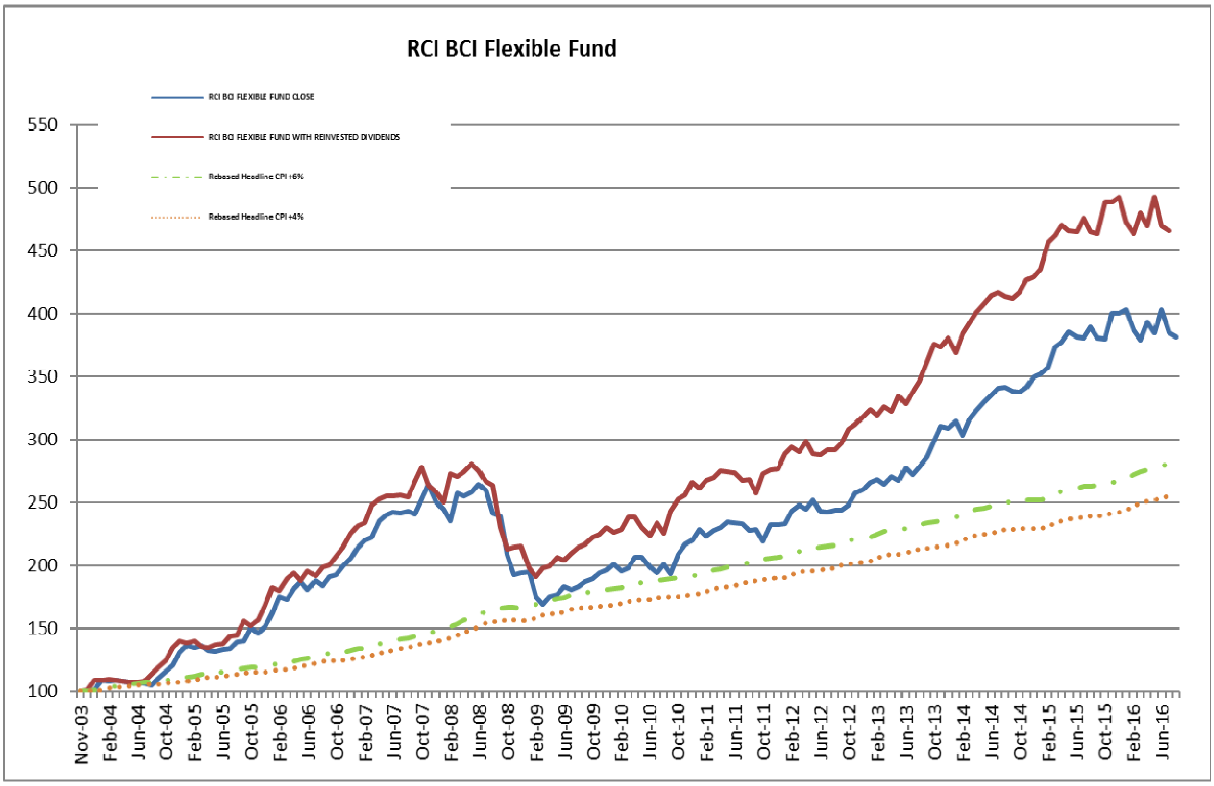
The market is extremely pessimistic on Gilead's Hep C future. They are most concerned about increased competition from generics. The below graphic from a medical publication shows the expected treatment rate of Hepatitis C around the world. We can see that there is still a lot of growth to 2020 but Gilead's market share is expected to decline considerably from its current 80%.

Exhibit 20: Global Estimated Treated Patients and Spending on Viral Hepatitis through 2020; Estimated 180 Million Infected



RCI BCI Flexible Fund – Down 1.72% over 12 months which underperformed the JSE Top 40 which fell 1.38%. Our bet on a weaker rand has not yet paid off, and in the short-term, the rand could get a bit stronger

Please contact Maggie on 011 706 1420 for any help on your unit trusts.



RCI BCI Flexible Fund fell 0.837% for July closing at 381.20c per unit. The JSE top 40 fell 0.13% for July so we underperformed this month. Over a year, the Overall Index is down 1.38% and our fund is down 1.72%. That is a 0.34% underperformance. That is not enough to make us happy. We have set up our portfolio to benefit from a weaker rand which might have a bit of strength in the short-term, now that the downgrade has been avoided and the cash must soon start flowing into South Africa to fund the SA Brews buy out.

Unit trust has flexibility – happy to take small amounts

The unit trust has the flexibility to buy and sell shares and to change weightings more frequently than in an individual portfolio. We are happy to take small amounts into the unit trust (from R1 000 per month or lump sums of R10 000). As you will not pay commission to any agents there is no cost to get in and out of our fund. On selling, the amount you receive back will depend on our performance.

To conclude

The strength of the rand from the end of January to the middle of August has caught us a bit by surprise. However, we invest for three to five year performance as our guess as to what might happen in the next few months is no better than the next person's.

We believe that over the next five years the rand is likely to weaken substantially as the metal prices are likely to be weak, resulting in a weak currency and a shortage in tax revenue for South Africa. The two bright spots on the horizon are tourism and agricultural products (provided the drought lifts and an average, or better, rainfall is received). Thus we continue to invest strongly in rand hedges and in South African companies paying a high but sustainable dividend yield.

We aim to be the best family office in South Africa.

Thank you for being our clients.

Best regards

Di and Alan