

# South Atlantic Capital Management Group, Inc.

## Investment Management

### December 31, 2015 Portfolio Review

#### COMPOSITE PERFORMANCE SUMMARY

##### South Atlantic Capital (SACMG) versus S&P 500 Annualized as of 12/31/2015

	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Since Inception*	Total Return Since Inception*
SACMG Core Equity <sup>1</sup> (Net)	(5.34%)	(5.34%)	8.46%	7.94%	14.15%	7.17%	11.96%	1,399.61%
S&P 500 <sup>2</sup>	1.38%	1.38%	15.13%	12.58%	14.82%	7.31%	9.04%	696.61%

\*Inception date of South Atlantic Capital's composite is 1/1/1992.

South Atlantic Capital is an independent investment adviser registered with the State of North Carolina and the Commonwealth of Virginia. South Atlantic Capital claims compliance with the Global Investment Performance Standards (GIPS®). The firm maintains a complete list and description of composites, as well as GIPS® compliant presentations, which are available upon request by calling (910) 763-4113, or emailing [info@southatlanticcap.com](mailto:info@southatlanticcap.com). Ashland Partners & Co., LLP, our independent verifier, has verified South Atlantic's compliance on a firm-wide level for the period of January 1, 1992 to June 30, 2015. All returns are net of management fees and include reinvested dividends and interest. Past results are not indicative of future investment results.



#### INVESTMENT PHILOSOPHY

Before reviewing the market environment, we want to say that we are not happy about the drop in portfolio values. However, over the last twenty five years our experience has been that during high market volatility- even when driven by real concerns- underlying business values are typically overlooked. In these periods, it's extremely important to consider whether losses are permanent or temporary after reviewing the prospects and risks specific to that investment.

Fundamental to our philosophy is a focus on investing in companies that maintain their financial strength and ability to add long term value during downturns by taking advantage of the attractive investment options available. We think this significantly diminishes the risk of permanent loss.

Intrinsic values for companies may not be reflected in a panic stricken market but history illustrates that ultimately stock prices reflect intrinsic value. We argue the biggest risk of permanent loss in our portfolios is not China, oil prices, a recession, and certainly not bank problems but fear driven selling which can turn a temporary loss into a permanent loss by not allowing values to be realized. As we've experienced before and summarized below, many of our holdings have remained in a position to take significant actions that should add to long term per share value.

- **Berkshire Hathaway** through its cash on hand, operating cash flow, plus \$10bb borrowed for the Precision acquisition was able to buy the shares of Precision Castparts that didn't own for \$31.7bb on January 29th. Additionally, they bought the Van Tuyl Group which includes 81 automobile dealers in 10 states for \$4.1bb in the first quarter of 2015 as well as 262.9 million shares of Kraft Heinz for \$5.26 billion on July 1, 2015. Precision Castparts earned \$1.5 billion in 2015.
- **Wells Fargo** had the capital strength and liquidity to purchase approximately \$25 billion in loans from Ge in 2015 with another \$35 billion expected to close in the 1st and 2nd quarters of 2016. They also bought back shares reducing their share count by 2%. In our opinion, the Ge acquisitions should lead to loan growth close to 10% in 2016.
- **Enterprise Product Partners** takes less commodity risk than most MLP's which along with its uniquely integrated system of fee based assets backed by long term contracts makes it one of the industry's strongest credits. A combination of retaining over \$1bb in cash flow to invest in future projects and continued strong support from the founding family which has reinvested \$100 million in dividends back in the company so far this year allows the company to be less dependent on the equity markets which are currently prohibitively expensive for most MLP's to profitably finance new projects.

Organic growth and acquisitions led to a \$7.1 billion increase in productive assets in 2015 and they have funding in place for \$6 billion of projects expected to come online in 2016-2017. We feel this is much faster growth than we expect other MLP's will be able to accomplish. Only 15 % of its business is subject to commodity risk and continued growth in cash flow should allow them to continue raising their dividend while maintaining a strong credit ratings of BBB+. From year end 2013 to year end 2017, we estimate Enterprise will have added to its productive assets by about 40% while increasing its share count by approximately 8%.

- **Cf Industries** – Nitrogen fertilizer prices have declined more than we expected given the step up in new US capacity (primarily CF) coming online from the 4th quarter through mid- 2016 as Chinese manufacturers benefit from lower coal prices and a lower yuan. Little capacity is

expected to come online from 2017-2020 and profitability should increase as the new capacity is absorbed by demand growth. However, CF remains solidly profitable today and a low cost provider due to cheap natural gas in the US as evidenced by their recent sale of 8.9% of production to a Midwestern farm co-op for \$2.8 billion. An insider's view of their value compares favorably to the market's assessment of total enterprise value for CF of about \$10 billion. The co-op contract along with operating cash flow enabled a \$4bb or 17% expansion in capacity net of the coop sale while reducing the share count by 33% since 2013 when the projects began. This means they have increased production capacity per share by 75% while adding \$3.4 billion in net debt or 34% of enterprise value based on the market's reckoning but 11% based on the value the co-op puts on their production.

- **Oaktree Capital's** strong reputation in distressed debt and high yield bond investing helped them raise \$22.5bb in commitments in 2015 as their opportunity set increased. Most commitments are not yet invested or earning fees and represent strong growth compared to \$78 bb of assets currently earning fees. We expect further capital raises. \$19 billion of the new commitments are in closed end funds that earn a 1.5% fee versus a 1% fee for their other funds. When invested, these commitments will substantially increase total management fees. Furthermore, \$19bb of the new commitments are in funds which earn an incentive fee if return hurdles are met. Current incentive fee earning assets are \$31.9bb, so this dry powder when invested will represent a 59.7% increase in incentive fee earning assets and all told should provide a significant boost to earnings.
- **Phillips 66** has already spent approximately 2/3's of a \$15 billion expansion in their mid- stream and petrochemical businesses. The projects are expected to grow operating profit at their midstream business by \$1billion and by \$1.3 billion at their 50% petrochemical joint venture with Chevron (which is self- funded) by mid- 2017. Their cash flow and ability to sell assets to a publically traded mlp they control (Phillips 66 Partners) has allowed them to maintain a modest net debt to capital ratio of 22% while funding the projects and reducing shares by 33%. Phillips 66 Partners (PSXP) is one of the very few MLP's that trades at a low enough dividend yield to make future projects feasible and currently trades at a 5% yield versus 15%-20% for many MLP's. Both companies could be major beneficiaries of the distressed selling we expect in the mid –stream industry through the credit worthiness of Phillips 66, the MLP's access to the equity markets and potential support from Berkshire Hathaway which owns 14% of the parent company.
- **Twenty First Century Fox** was able to reduce its share count by 9% over the last year at what we think are attractive prices by utilizing \$5.6 billion of their \$8 billion in excess cash balances which were earning next to nothing.

## INVESTMENT ENVIRONMENT

The markets are currently hypnotized by falling oil prices, a slowdown in China, and uncertainty over what the Fed might do. The S & P 500 traded at 16.75 times forward earnings estimates at year end. Given a somewhat stretched market valuation, its understandable *investors would assume the glass is half empty* and react violently to the slowdown in China making January one of the market's worst months ever.

Economic forecasting is not what we hang our hat on as we've already discussed but we feel these fears are overdone. If a global slowdown pulled us into a recession, it would be the first time. The manufacturing sector is weak and suffering from a 22% increase in the dollar over the past year but exports to China represent just 1% of GDP, while 70% of GDP is driven by consumer spending. We export much more to Canada, Mexico, and even Europe. Commodity markets reacted violently to a recent announcement from China showing a slowdown in its industrial sector for the 6th straight month, but looking closer at the numbers, consumer spending in China which we think is more important to our portfolios rose 10.7% for the year. China is making some progress as it attempts to transition from an economy driven by a government top down industrial buildout to a consumer driven economy. The risk in China is more for emerging market countries dependent on selling them commodities. Other than Franklin Resources which has \$17 per share in cash we are not very exposed to that. We think we are more exposed to the Chinese consumer and much more exposed to the US economy.

The US consumer which drives 70% of our economy is fairly strong benefitting from job growth, wage increases, and lower oil prices. We think the market reacting so negatively to lower oil prices is a telltale sign there is too much fear in the market. Consumer debt has dropped from 127% of disposable income in 2007 to about 100% today and debt service costs have been reduced to 13% of income on the eve of the crisis to 10% today. Homeownership rates have dropped from 67% to 62% creating the potential for increased housing starts as growth rates in household formation have increased recently. Spending might fall if consumers get spooked but wages are probably a bigger threat since Americans are not as exposed to the stock market as they are to falling home prices since only 14% of household worth is invested in the stock market.

Lower oil prices represent a large tax break in our opinion and a net positive for the economy even though defaults have raised the cost of high yield debt. Oil prices have fallen by about \$80 a barrel from roughly \$110 to \$30 per barrel. The U.S. consumes about 20 million barrels per day with 10 million produced in the US. That's a reduction of \$570 billion per year. Even if just 50% of that flows through to the consumer in lower gas prices that's \$285 billion per year. We think that's a positive for the consumer unless the oil and related industries lose 2.85 million jobs paying \$100,000 per year which is highly doubtful since employment in oil and gas extraction and support activities was 538,000 in October of 2014 and has declined by 35,000 jobs through April of 2015 according to the Energy Information Association.

The Chinese consumer on the other hand represents 35% of GDP versus 70% in the U. S. and on a per capita basis they spend \$3,900 annually ranking 106th globally behind Swaziland but ahead of Algeria. They won't be able to turn a \$10 trillion economy on a dime but overtime the Chinese consumer represents an opportunity while a slowing Chinese Industrial sector represents a problem for many emerging market economies which supply commodities to China. An example of opportunities for our portfolio from a growing Chinese consumer is the fact that they have 2,000 aircraft operating for a country of 1.4 billion people while the U. S. with 300 million people has 6,000 planes operating.

**Repeat of 2000 market or recession?**

*“More money has been lost predicting a recession than in the recession itself”*

*-Peter Lynch*

For many companies, we think the threat of recession is priced into their shares. The slight rise in the market last year was due in total to very large increases in the momentum oriented buying of FANG stocks, Facebook, Amazon, Netflix, and Google while 50% of the stocks in the S&P 500 fell with a median decline in value of 15.93% and certainly have fallen further this year. At the end of last year, the median stock of the top performing quintile of the S&P 500 “popular stocks” has risen to its highest one year forward P/E multiple in more than a decade. The popularity portfolio has only been **pricier** than it is today about 15% of the time since 1990. At the same time the median stock of the lowest performing quintile has only been **cheaper** about 30% of the time in the last 25 years and the spread in valuation between the “popular stocks” and the “disappointing stocks” hasn't been this wide since the dot com boom of the late 1990's.

Popularity is not a good thing when buying a stock. The enthusiasm around these stocks means the price is set by optimism which generally means the stock has little upside and significant downside. You can see the optimism in these stocks through anemic free cash flow yields which don't allow for the significant share count reduction which we like.

We think the performance of the “unpopular stocks” is more akin to the disparity in spreads of the late 1990's than a prediction of a recession. However, again, we hang our hat more on how an investment will fare through a recession than on predicting a recession. Of course a recession will happen again one day.

You can see below how our top holdings as of 12/31/2015 fared in the last recession.

***Earnings per Share***

	2007	2008	2009	
Berkshire Hathaway	\$6,223	\$6,230	\$4,876	-21.6%
Wells Fargo	\$2.38	\$0.70	\$1.75	-26.5%
Enterprise Product Partners	\$1.92	\$2.04	\$2.17	+13%
Twenty First Century Fox*	\$3,498	\$4,060	\$3,085	-11.8%
Oaktree Capital**	53bb	50bb	73bb	+37.7%
Philip Morris	\$2.80	\$3.31	\$3.29	+17.5%
Scripps Network Interactive	\$1.64	\$1.63	\$1.65	+1%

*Average earnings of top holdings during worse recession than we're likely to see --- +1.3%*

*\*Spinoff newspapers in 2014 so we show operating profit from remaining cable, tv, and film assets.*

*\*\*earnings data not available before 2009 so we show the most important metric of assets under management*

I'm sure this is much more detail than anybody wanted but hopefully you will take comfort in the fact that we think the portfolio is well positioned and are adding to positions during the price decline. While it may sound self- serving, we urge you not to be concerned about short returns.

Please feel free to contact me.

Best regards,

Eddie Nowell

## **DISCLOSURES**

<sup>1</sup>**Core Equity Composite** contains all fully discretionary accounts invested in equities excluding accounts that use significant leverage. For comparative purposes it is measured against the total return for the S&P 500. It includes accounts managed for capital appreciation as well as accounts managed for a combination of capital appreciation and current income. The equity securities are typically mid cap and large cap value oriented U.S. equities and ADR's of similar capitalization. The portfolios also include equity securities that provide higher current income such as master limited partnerships, real estate investment trusts and similar securities that "pass through" most of their cash flow as distributions. The portfolios may from time to time invest in fixed income securities and various hedges such as gold backed ETF's as conditions warrant. The portfolios are typically invested in 15-25 positions but have held fewer than 15 positions in the past.

<sup>2</sup>**S&P 500 Index** has been widely regarded as the best single gauge of the large cap U.S. equities market since the index was first published in 1957. The index has over U.S. \$4.83 trillion benchmarked, with index assets comprising approximately U.S. \$1.1 trillion of this total. The index includes 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities and includes the reinvestment of dividends of companies in the S&P 500.

Returns are presented net of management fees and include the reinvestment of all income. The U.S. Dollar is the currency used to express performance. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request, as is GIPS compliant presentations and lists and descriptions of South Atlantic Capital's composites, by emailing [Info@SouthAtlanticCap.com](mailto:Info@SouthAtlanticCap.com) or calling (910) 763-4113. Portfolio composition is subject to change at any time and references to specific securities, industries, and sectors referenced in this letter are not recommendations to purchase or sell any particular security. Current and future portfolio holdings are subject to risk.

The discussion of our firm's investments and investment strategy (including current investment themes, the portfolio managers' research and investment process, and portfolio characteristics) represents the firm's investments and the views of the investment adviser, at the time of this letter, and are subject to change without notice.

Past results are not indicative of future investment results. An investor should further understand that future results may result in losses for account holders.



### **EDWARD D. NOWELL**

Edward D. Nowell is President, founder and sole portfolio manager of South Atlantic Capital Management Group, Inc.

Mr. Nowell has over thirty years of experience in the finance business. Prior to founding South Atlantic Capital he worked in the structured finance department of Bankers Trust Company, New York as an Assistant Vice President. His primary responsibility was arranging bank financing for leveraged buyouts led by Kohlberg Kravis Roberts & Company. During graduate school, he interned with Merrill Lynch's Capital Markets Group in New York. Later, he served as an institutional fixed income sales representative for Carolina Securities/Prudential Bache Securities and worked with Fox, Graham, and Mintz, Securities. Mr. Nowell graduated from the University of North Carolina with a B.S. in Economics and received his M.B.A. from the University of Virginia.

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**SOUTH ATLANTIC CAPITAL MANAGEMENT GROUP, INC.**  
**CORE EQUITY COMPOSITE**  
**ANNUAL DISCLOSURE PRESENTATION**

Year End	Total Firm Assets (millions)	Composite Assets (USD) (millions)	Number of Accounts in Composite	Annual Performance Results Composite		S&P 500	Composite Dispersion	Three Year Annualized Ex-Post Standard Deviation	
				Gross	Net			Core Equity	S&P 500
2015	42.0	20.9	67	(4.39%)	(5.34%)	1.38%	1.14%	11.55%	10.47%
2014	40.7	26.8	68	8.20%	7.14%	13.69%	1.12%	7.99%	8.97%
2013	37.2	23.1	56	26.97%	25.76%	32.39%	2.23%	9.88%	11.94%
2012	28.6	17.3	47	13.02%	11.93%	16.00%	1.83%	11.19%	15.09%
2011	25.3	15.2	43	3.60%	2.56%	2.11%	2.54%	15.55%	18.71%
2010	22.0	14.4	40	20.20%	19.02%	15.06%	3.42%	17.94%	21.85%
2009	18.6	13.0	36	46.22%	44.77%	26.46%	5.32%	17.26%	19.63%
2008	12.4	8.4	38	(25.99%)	(26.68%)	(37.00%)	2.30%	12.59%	15.08%
2007	17.4	11.9	37	(1.89%)	(2.83%)	5.49%	3.03%	9.31%	7.68%
2006	22.4	12.6	36	12.08%	11.11%	15.79%	2.52%	8.75%	6.82%
2005	12.4	10.8	33	0.79%	(0.16%)	4.91%	3.12%	11.08%	9.04%
2004	12.3	11.1	30	20.37%	19.24%	10.88%	3.37%	12.60%	14.86%
2003	9.2	8.5	23	35.31%	33.95%	28.68%	4.38%	13.67%	18.07%
2002	6.9	6.4	21	(3.21%)	(4.20%)	(22.10%)	6.43%	14.21%	18.55%
2001	7.6	6.7	17	5.18%	4.14%	(11.89%)	2.36%	14.06%	16.71%
2000	7.1	5.9	14	13.91%	12.87%	(9.10%)	3.77%	13.65%	17.42%
1999	6.4	5.4	13	8.94%	7.90%	21.04%	10.61%	12.67%	16.52%
1998	6.5	5.4	13	6.09%	4.93%	28.58%	5.60%	12.07%	16.01%
1997	5.1	4.7	11	41.04%	39.60%	33.36%	5.15%	11.12%	11.14%
1996	3.6	3.3	8	23.66%	22.42%	22.96%	3.34%	11.76%	9.58%
1995	2.9	2.7	6	48.47%	47.03%	37.58%	3.31%	10.46%	8.22%
1994	2.0	1.9	5	7.76%	6.69%	1.32%	8.02%	11.05%	7.95%
1993	1.8	1.7	4	23.29%	22.07%	10.08%	3.33%		
1992	1.3	1.2	3	13.86%	12.85%	7.62%	0.00%		

***Core Equity Composite** contains all fully discretionary accounts invested in equities excluding accounts that use significant leverage and for comparative purposes is measured against the total return for the S&P 500. It includes accounts managed for capital appreciation as well as accounts managed for a combination of capital appreciation and current income. The equity securities are typically mid cap and large cap value oriented U.S. equities and ADR's of similar capitalization. The portfolios also include equity securities that provide higher current income such as master limited partnerships, real estate investment trusts and similar securities that "pass through" most of their cash flow as distributions. The portfolios may from time to time invest in fixed income securities and various hedges such as gold backed ETF's as conditions warrant. The portfolios are typically invested in 15-25 positions but have held fewer than 15 positions in the past. The minimum account size for this composite is \$50,000.*

South Atlantic Capital claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. South Atlantic Capital has been independently verified by Ashland Partners & Company LLP for the periods January 1, 1992 to June 30, 2015.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Core Equity Composite has been examined for the periods January 1, 1992 to June 30, 2015. The verification and performance examination reports are available upon request by calling (910) 763-4113, or by emailing [info@southatlanticcap.com](mailto:info@southatlanticcap.com).

South Atlantic Capital is an independent registered investment adviser registered with the State of North Carolina and the Commonwealth of Virginia. The firm maintains a complete list and description of composites, as well as GIPS® compliant presentations, which are available upon request by calling (910) 763-4113, or by emailing [info@southatlanticcap.com](mailto:info@southatlanticcap.com).

Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Composite policy requires a three month, temporary removal of any portfolio incurring a client initiated external significant cash inflow of at least 25% of portfolio assets. The temporary removal of such an account occurs at the end of the prior month in which the external significant cash flow occurs and the account re-enters the composite at the end of the second full month after the cash flow. Additional information regarding the treatment of significant cash flows is available upon request. Composite returns represent investors domiciled primarily in the United States. As of December 31, 2014, less than 1% of composite assets represent non-fee paying accounts. Past performance is not indicative of future results.

The U.S. Dollar is the currency used to express performance. Returns are presented gross and net of management fees and include the reinvestment of all income. Returns are presented after trading expenses but before any applicable taxes. Actual management fees were used to calculate composite performance for each year presented. The annual composite dispersion presented is a size-weighted standard deviation calculated for the accounts in the composite the entire year. The annual dispersion and the standard deviation are calculated based on net returns. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request, as is GIPS compliant presentations and lists and descriptions of South Atlantic Capital's composites, by emailing [info@southatlanticcap.com](mailto:info@southatlanticcap.com) or calling (910) 763-4113.

South Atlantic Capital's management fee schedule for accounts with assets up to \$500,000 is 1.25%. For accounts with assets between \$500,000 and \$5,000,000, the management fee schedule is generally set at 1.0% per annum, and is negotiable for accounts with assets over \$5,000,000. Actual investment advisory fees incurred by clients may vary.

South Atlantic Capital recently engaged Ashland Partners & Company LLP to extend the examination period of our composite back to January 1, 1992 versus the previous begin date of January 1, 2002. During the examination process, an error was discovered in an account where an inflow of securities was mistakenly included in the account's return. This issue caused gross composite returns for 2001 to change to 5.18% versus a previously reported return of 6.92% and net returns that year to change from 5.86% to 4.14%. Changing that account's return along with eliminating an account that was in liquidation from the composite caused our dispersion to narrow in 2000 from 4.48% to 3.77% and from 6.23% to 2.36% in 2001.

The Core Equity composite was created on March 1, 2011.

**Independent Accountant's Verification Report**

Mr. Edward D. Nowell, President  
South Atlantic Capital Management Group, Inc.:

We have examined whether (1) South Atlantic Capital Management Group, Inc. (the "Firm") has complied with all the composite construction requirements of the Global Investment Performance Standards (GIPS® standards) on a firm-wide basis for the periods from January 1, 1992, to June 30, 2015, and (2) the Firm's policies and procedures are designed to calculate and present performance results in compliance with the GIPS standards as of June 30, 2015. The Firm's management is responsible for compliance with the GIPS standards and the design of its policies and procedures. Our responsibility is to express an opinion based on our examination.

**Scope of Work**

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the Firm's compliance with the previously mentioned requirements; evaluating the design of the Firm's policies and procedures previously referred to; and performing the procedures for a verification required by the GIPS standards and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

**Opinion**

In our opinion, in all material respects,

- the Firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis for the periods from January 1, 1992, to June 30, 2015; and
- the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of June 30, 2015.

This report does not relate to any composite presentation of the Firm that may accompany this report, and accordingly, we express no opinion on any such performance.

*Ashland Partners + Company LLP*  
Ashland Partners & Company LLP  
October 21, 2015