July 2022

Dear Investor,

SECOND QUARTER OF 2022

Welcome back to the good old days

The recent flow of macro events has certainly been challenging. From COVID-19 to war in Ukraine to global inflation that's on the march. And, without passing go, we've been hit with higher interest rates. When will we go back to 'the good old days'?

Consider the following editorial from Harper's Magazine in the US: *"It's a gloomy moment in the history of our country. Not in the lifetime of most men has there been so much grave and deep apprehension; never has the future seemed so incalculable as at this time. The domestic economic situation is in chaos. Our dollar is weak throughout the world. Prices are so high as to be utterly impossible. The political cauldron seethes and bubbles with uncertainty. Russia hangs, as usual, like a cloud, dark and silent, upon the horizon. It is a solemn moment. Of our troubles no man can see the end."* The editorial was written in 1847!

New problems continuously arise and evolve. Some die young while others just seem to hibernate. When there are no problems, it is simply a lull between the waves. Every storm finds its way into the markets; some to a greater degree than others. The markets did not like COVID-19. In fact, they panicked at a pace never seen before. The easing of monetary policy calmed the nerves but now markets are dealing with rising interest rates. This has resulted in a more gradual but persisting sell-off.

We can't predict storms, but we can assess price risk. How do we make the right investment decisions among pounding storms? We cannot promise that we have the recipe to sail through every disaster, but we have learned to harness certain timeless principles.

We have all recently read about the mighty Bitcoin crash. If you invested $100 in Bitcoin in November 2021, you had a mere $32 at the end of June 2022. The crypto currency sceptics will say that they told you so. They will tell you that something that generates no income has no value. This is obviously not true. A tulip generates no income but for as long as it can apologise for bad behaviour or express our condolences, it will have monetary value. However, even this is beyond the capabilities of a crypto currency, which is just a random collection of digits that lives in an intangible ether. Those smirking friends will say that you were looking for trouble – and boom, it found you.

Well, let's consider Shopify. This very successful company enables small and medium-sized enterprises in a perfectly tangible way. Shopify generates $4.6 billion of revenue, which has grown from $673 million generated in 2017. Between 2019 and 2021, it gained a million new clients and now, 597 million customers buy from Shopify-enabled stores. It certainly has intrinsic value. Yet, if you invested $100 in Shopify in November of 2021, you would have been left with only $19 at the end of June. You would have lost more money investing in a perfectly sound business than investing in Bitcoin at the height of the most recent crypto currency bubble.

What went wrong at Shopify? Nothing. When money chases money as everybody wants a piece of the alchemy, prices go to levels that are unhinged from any version of reality. And trouble follows. In both examples, the reason for losing so much money was due to the heights these asset prices achieved, not due to the nature of the storm that triggered panic selling. Almost all stocks have been pushed lower by the macro backdrop. In most cases, exactly how far has depended on the reasonability of the share price before the bear market started.

How do you avoid big mistakes like buying Bitcoin and Shopify towards the end of 2021? If you went to a poultry auction and found all bidders manically shouting at the auctioneer to land the highest bid on a goose they believe to lay golden eggs, you might take a backseat. The crowd's conviction will stem from the fact that the price couldn't possibly reach such insane levels if the goose laid anything other than golden eggs. Although you would

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have no way of knowing the nature of the goose's eggs upfront, you would surely not pay anything more than the regular price of a good goose. Avoiding a mistake would be less about your poultry knowledge and more about your knowledge of human behaviour. You would not have required genetic analysis; only the estimated price of a goose. So, principle number one: if you see a goose, it is probably worth the price of a goose.

Trick number two: don't leave the auction. Something will trigger uncertainty in the crowd – perhaps a macro event – and that very goose might sell for the price of an infertile chicken before the day is done. That is when you should offer the approximate value of a goose of regular breeding. Again, it's not about geese or chicken but about human greed that swings into fear. This principle is true for any asset class, and we apply it accordingly.

We're still at the auction. Currently, we are especially adding to our positions in companies that operate in the semiconductor industry. They have crucial utility, as semiconductors are at the heart of technological development. But the turn from euphoria in technology-related stock prices to a rush for the door has resulted in the prices of these companies moving in the direction of the infertile chicken. We have also been adding to Howden Joinery, a pre-built kitchen manufacturer based in the UK. The prospect of higher interest rates has already driven its price all the way down to chicken levels. However, Howden has a long record of offering popular products at the right price while generating consistently high returns on capital. Lastly, as we discuss below, we have added a new holding to your portfolio and exited another.

Portfolio Updates

During this quarter, we exited your holding in Twitter completely. The proceeds were distributed across a number of your other holdings including Howden Joinery, Taiwan Semiconductor Manufacturing Company, Applied Materials, Wix.com as well as a new holding in Adobe.

Twitter

On 4 April 2022, the market was alerted to the fact that Elon Musk had accumulated shares in Twitter and owned 9.1% of the company's outstanding shares. Soon thereafter, it was announced that he would also be joining the board of directors. However, before this was affected, Musk decided not to join the board but to make an offer to buy the whole company instead, at a price of $54.20 per share. We admit that we initially didn't believe this to be a serious offer, but hoped that this action might prompt other, more suited potential acquirers to consider making an offer for the business. The initial offer price was below our assessment of Twitter's value.

In the weeks that followed, there was immense speculation about the future of Twitter: how Musk might pay for the deal, who might partner with him on the transaction and how Twitter might change. We also saw glimpses of the disruption this approach created internally at Twitter, as people resigned and hiring was halted. Management focus took a backseat to spending time with advisers, bankers and lawyers.

By 21 April, Musk announced that he had received financing commitments for the deal and that the offer would not be subject to business due diligence. This meant he was indeed serious about buying Twitter and it seemed that no other parties were interested in making a competing offer. The Twitter board accepted the offer on 25 April. We had limited insight into the likelihood of a deal ultimately concluding, but we saw enough indications that it would be detrimental to the culture of Twitter, whether it closed or not. Hence, we decided to sell your whole position, realising an average sale price of around $51. Your investment in Twitter unfortunately never reached the value we identified at the outset, but recent events had reduced the likelihood of this goose laying golden eggs.

As noted above, the proceeds were invested across a number of other holdings that sold off in sympathy with most other technology shares.

Adobe

One such company is Adobe. It is probably known to most of you as the creator of the pdf document format and free Adobe pdf viewer.

However, their business has really been built on serving creative professionals, for whom Adobe's Photoshop, Lightroom, Illustrator (and other products) are the fundamental tools used every day to do their jobs. In these areas, Adobe has a near-monopoly, with their software taught from university level and entrenched in the standard ways of working. The word 'photoshopped' has even made it into the dictionary!

Over the past decade, Adobe has successfully made the switch from physical software licensing to a subscription cloud-based model, with growth of over 20% a year and impressive profit margins. Adobe is now very well positioned as an enabler of the digitization of business processes and growing creator economy. They have also been building an interesting digital experiences business which offers marketing, customer journey and data analytics capabilities. Adobe has many of the features we like in a business: a strong balance sheet, an excellent leadership team who are aligned with shareholders, a wide moat through their entrenched position, a roadmap for continued innovation and a growing and expanding addressable market. We added Adobe to your portfolio as we believe this quality and growth potential isn't reflected in the share price.

Howden Joinery

As we have described in earlier letters, Howden is the largest kitchen manufacturer in the UK. They have a vertically integrated business model which produces, distributed, and sells kitchens across more than 800 depots in the UK and France.

The business has a competitive advantage in the way that it enables thousands of builders and kitchen installers to earn a living: Howden provides in-stock inventory and financing terms to the builders enable them to complete their projects without the need for significant working capital. Howden’s customer is the builder and they’ve designed their business around catering to their specific needs.

The “do-it-for-me” segment of the market is growing, boosted by an aging population of property owners and an aging housing stock. The business continues to grow, to open more depots and to earn enviable free cash flow margins on their sales. It has no financial debt and manages its balance sheet quite prudently.

Howden will never generate the type of revenue growth that Shopify did. But, we think it will grow free cash flow faster than the market currently implies. We were able to invest in Howden at a very attractive price compared to what we think the business is ultimately worth.

Operational Updates

This quarter we welcome Philasande Ntshiba to the Capensis team. Phila joined Granate Asset Management in 2020 and quickly demonstrated her immense skill in dealing with difficult areas of the business. Phila is not only a chartered accountant, but also a talented artist. Phila is the head of finance and risk here at Granate and you should expect communications for her to ensure that all your regulatory information is up to date.

Conclusion

This letter should be read in conjunction with your quarterly investment statement which contains all the financial information relevant to your account. It continues to be a pleasure and a privilege to manage your capital. As always, we invite you to contact us if there is anything you would like to discuss. We find that there are valuable learnings in portfolio discussions, especially when clients take opposing views.

Your partners in long-term value,

Alex, Catherine, Henno, Paul, Phila and Simone

Disclaimer

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