July 2024

Dear Investor,

SECOND QUARTER OF 2024

At a recent investment conference, we were asked to describe our investment process as a culinary dish. After careful (and colourful) consideration, we realised that our investment process is best represented by the “chef’s special” or the “dish of the day” that is scribbled daily on the blackboard of options.

Why do we think so?

With some artistic freedom, we can consider our investment team as the kitchen staff in a restaurant. We have members with different areas of interest, skills and backgrounds, but we all work together for one goal: to create the most enjoyable plate of food possible. We aim to nourish and delight everyone coming to our restaurant.

How do we do this?

Every day our team goes out to find ingredients to use in the kitchen. We have a clear idea of what we regard as quality components, but we also know that even the best ingredients need to be optimally ripe before they’re considered for the recipe. So, our team casts a wide net. A few of us go into the garden to harvest, or into the forest to see what nature has provided overnight. Some might focus their efforts on the town market where we can select from the best local produce or browse through specialty stores for a few special ingredients. We even have members looking through our own pantry to see if there are ingredients that we’ve missed or that have reached their optimal aging window.

Once we have foraged and found what we like, we bring all the ingredients back to the kitchen. Here is where the magic happens. As a team, we consider the different elements that we have available to us, and we begin to design a dish that combines the best we have in front of us with the best we have inside of us. We consider all the potential options, and we always try to play to our strengths. With the help of the whole team, the dish begins to take shape.

Our dish starts with quality ingredients, but we aim for a dish that is better than the sum of its parts – mindful that it might take time to bake. This is an iterative process where we combine, taste, adjust, add, balance and taste again…and again and again. We utilise everyone's palate to ensure that the dish is perfectly cooked, that the seasoning is right and that everything is in balance.

Our dish will often look different from what we started with. We try to be rational and adjust to how the ingredients work together in practice. We don’t force ourselves to stick to Italian recipes, to remain a steakhouse or to only produce pastries. Our dish will be the best we can produce with the best we can find today.

This is also a reflection of a process that adheres to one of our fundamental beliefs: that the highest quality ingredients, mixed at the right time and cooked according to time-tested methods, will deliver the type of meal that we want to serve to friends and family – and eat ourselves. Every day.

This remains the process by which we construct your portfolio. We consider the quality of businesses according to the four qualitative pillars we have discussed in the past. These are the governance of a business, the strength of its balance sheet, the track record of its management team and its ability to sustainably generate cash flows.

Our cooking process involves buying these businesses when their prices make sense and holding on to these for as long as the investment case and expected return remains intact. We add and reduce positions to keep the portfolio in balance and we keep some cash available to stock up on ingredients when they are available on discount.

Bon appétit.

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Portfolio Updates

The main contributors to your performance during the quarter were once again your semiconductor businesses, as well as Interactive Brokers. Main detractors were the holding companies, Berkshire Hathaway and Exor. We added Lowe’s to your portfolio and bought more AIA Group.

Introducing Lowe’s (LOW)

Why did we buy Lowe’s, a hardware store in America?

If you ask anyone what they got up to in the dark days of pandemic lockdowns, you’ll likely hear one of a few common answers: started some sort of online exercise routine, baked sourdough or banana bread, or took on a DIY project. Hardware stores were declared essential services in most countries, staying open during lockdowns and taking advantage of the sudden interest in home improvement. As the world reopened and we could once again leave home, people returned to entertainment venues and spent less on their homes. This was further compounded by pressure on consumers’ pockets in a high interest rate environment. When we think there’s a cycle at play, it’s usually a good time to start digging. So, dig we did, focusing our efforts on the home improvement sector in the USA. Here we unearthed a surprising number of quality companies: well-established businesses with a competitive advantage, growing faster than the overall market, with operating leverage driving profit and cashflow growth, and generating high returns on their capital. A number didn’t pass our hurdles for various reasons, but the one we thought presented a good opportunity was Lowe’s.

Lowe’s is the second largest home improvement retailer in the USA founded in 1921, with over 1,700 stores across the country. These are large format stores selling tens of thousands of items, comparable to a Builder’s Warehouse. Lowe’s competes directly with Home Depot. The two have a similar share of the DIY market (serving individuals like you and me) but Home Depot has historically been a better company due to its much larger share of the professional (Pro) market (serving builders). With its existing store footprint in convenient proximity to builders, Lowe’s now sees a big opportunity to capture more of the Pro market. Under an ex-Home Depot executive as CEO, who has implemented a focused Pro strategy, Lowe’s has quietly been gaining ground. It has closed the gap on gross margins, operating margins and returns on capital and is showing early signs of outgrowing both the market and Home Depot, in the Pro segment. We think the market hasn’t fully appreciated the improvements in the business, creating an opportunity to buy a quality compounder at a reasonable price.

Lowe’s is a smaller position in your portfolio and the share price not at distressed levels. If the company continues to produce a growing stream of cash, your purchase price should eventually be a fraction of the value of your investment. It may well be a terrific opportunity for the very long-term investor.

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,

Everyone at Capensis Capital and Granate Asset Management

Disclaimer

This document is intended for the clients of Capensis Capital (Pty) Ltd. All data provided by Capensis, unless otherwise stated, is current as at 30 June 2024.

Capensis Capital (Pty) Ltd is an Authorised Financial Services Provider, regulated by the South African Financial Sector Conduct Authority. Registered office: 2nd Floor, Josephine Mill, 13 Boundary Road, Newlands, 7700.

More information about Capensis can be found at http://www.capensiscapital.com.

The value of your investments and the income from them may go down as well as up. It is possible that you may receive less than you invested. Past performance is not indicative of future performance.

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