CAPENSIS CAPITAL

April 2023

Dear Investor,

FIRST QUARTER OF 2023

This quarter marks the sixth birthday of Capensis Capital. Six years still places us firmly in the early years of our dream, so we remain grateful to all of you who decided to join us so early on the journey. We wrote our introductory letter that "our aim for Capensis is to build our corporate home for the next 40 years or more. We love what we do, and we hope to continue doing it for decades to come".

Thank you for making this dream a reality.

Investment Performance

Over the past six years, the portfolio has grown at 5.4% per annum. This compares to the benchmark of US inflation plus 6% with increased at 9.6% per annum.

Return	Capensis Capital		Benchmark (US inflation + 6%)	
	Total	Annualised	Total	Annualised
Since inception (6 years)	+37.2%	+5.4% p.a.	+73.7%	+9.6% p.a.
Last 3 years	+38.2%	+11.4% p.a.	+37.8%	+11.3% p.a.

Source: Interactive Brokers, US Bureau of Labour Statistics, Capensis

This letter is designed to be read in conjunction with your quarterly investment statement, which contains all the financial information. As always, feel free to contact us if you would like to discuss your portfolio.

Why we're positive on property (although it's a little lonely out here) – by Tyron Green

As a boy growing up in Johannesburg, I used to scour the property sections in the Saturday newspaper. (While this may sound like an unusual childhood pastime, I've been told by the team that it comes as no surprise). Over time, I got a feel for the value of properties in different areas and could see when there were potential bargains on offer. A good number of years later I bought my first property, did some renovations and ultimately sold it.

After moving to Cape Town, it took me four years to buy a home. This was a new market I had to research – and house prices were around double those in Joburg. But I did come across a property I thought offered good potential: an old house in Newlands, which I also renovated and later sold.

Finding these properties involved a fair bit of luck. But it also required time to investigate the areas in which they were located and an understanding of market dynamics to assess if they could offer a decent return.

I'm still on the hunt today, but now as part of a research team and on behalf of the clients. Therefore, there are a few differences. The properties our funds invest in are owned and managed by listed companies operating under a structure known as a Real Estate Investment Trust (REIT). This exempts them from both company and capital gains tax, if they pay out most of their earnings as distributions to shareholders. You own shares in selected REITs, and therefore shares of their underlying properties. These may be residential (e.g. apartments), commercial (e.g. offices), retail (e.g. shopping centres) or logistics related (e.g. warehouses).

And this is where the similarities come in. Because just as you'd consider for a personal investment (whether to buy and resell, or to buy and rent out), there are common factors to look for. Where is the property located and is there good demand from buyers or tenants? How many other developments are being built and could this dampen demand? If leasing the property out, how much is expected in rent – and could this increase over time? It is also important to consider property financing and whether this includes debt. How much of the bond repayment will rental income cover? And is there some wiggle room to provide for potentially higher instalments if interest rates aren't fixed and policy rates rise?

REITs usually buy properties using a mix of cash and debt, targeting an overall 'Loan to Value' (LTV) of around 40% (meaning that the property portfolio is 40% debt funded and 60% cash funded). To aim for stability and growth in dividends, a well-managed REIT generally tries to fix the interest rates on its debt (thereby avoiding pressure on cash flows if interest rates rise), consistently grow rentals (through contractual escalations) and keep expenses low (so that rentals grow faster than expenses). When evaluating potential investments, we therefore look for strong balance sheets (low LTVs with longer-dated and diversified sources of debt), sensible interest rate hedging policies and the ability to generate healthy cash flows that can grow. Given that we're investing in a company and not merely a building, we also conduct a thorough management and governance review.

An investment truth from both my personal and professional experience: Property moves in cycles

Property values (and REIT share prices) move up and down in cycles, which can take years to play out. This can create opportunities as these cycles get close to peaking or bottoming, because share prices tend to be amplified around property values as extreme optimism moves to extreme pessimism (or vice versa). When times are good, interest rates are low and economies are firing, costs to finance new buildings are low and demand for property is strong. Office blocks are fuller, shops are busier and more people can afford their own place to stay. Demand outpaces supply, which results in rising property prices and higher rent. This is usually when more developers want to get in on the action and extra space is built until the supply and demand equilibrium reverses. With property in oversupply, the market becomes more competitive. Vacancies rise, rentals come under pressure as landlords try keep existing tenants, and property prices decline.

We have been in a down cycle for some time now, especially in the retail and office sectors. In retail, a longstanding narrative has been the threat posed by online shopping, with many predicting the slow but inevitable death of brick-and-mortar trade. The Covid pandemic heightened these fears as in-store shopping was restricted, accelerating the adoption of online alternatives and forcing the closures of outlets that were unable to adapt or stay afloat for long enough. Similarly, as workplaces emptied and working from home became the new normal, the values of office blocks plummeted. Given that many employers have since stuck with this model or have implemented hybrid working policies, the sector remains out of favour. Overall sentiment has been driven lower still by an environment in which inflation – and therefore living costs – are rising, while higher interest rates place growing pressure on both individual and corporate balance sheets.

When conditions seem most dire, sparks are most visible in the gloom. Many REIT management teams are commenting that they believe we are at or close to the bottom of the current cycle – and our process has uncovered what we believe to be several stand-out opportunities for outsized returns once the cycle turns. While we cannot predict when this will be and the ride may yet be bumpy if we are early, we are confident in the fundamentals of the REITS we have chosen to invest in and in the durable attractiveness of their property portfolios.

Retail is not dead

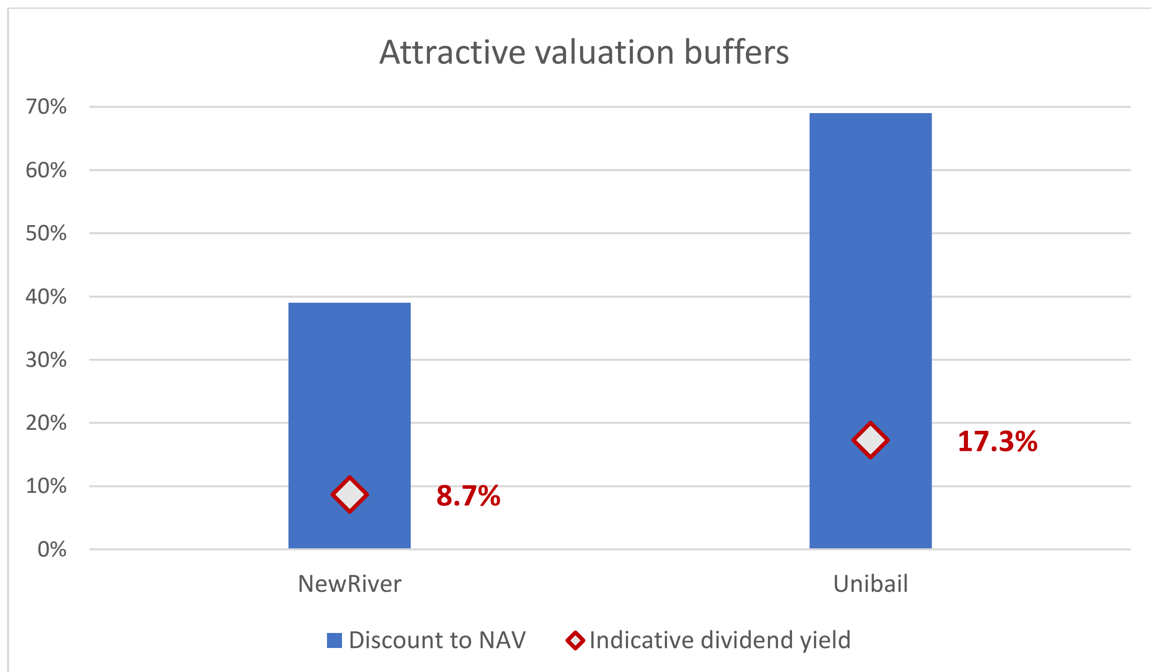
Two of your new investments are focused on retail properties: Dutch-domiciled Unibail-Rodamco-Westfield (Unibail) and UK-based NewRiver. While Unibail operates and manages large retail shopping malls primarily based in Europe (72%) but also in the US (22%) and the UK (6%), NewRiver focuses predominantly on value retail outlets and community shopping centres in its home country. Both have been caught in the negative narrative surrounding the retail sector but have managed to hold up due to attractive property fundamentals (with proximity and ease of access being a key priority). They have also each undertaken reforms to position themselves more favourably once conditions improve. Having weathered significant property write-downs of as much as 54%, Unibail has taken decisive action to strengthen its balance sheet. Under new management it cut its dividend in favour of reducing debt and is running its balance sheet more conservatively. Now, Unibail holds

a significant proportion of long-dated debt, has sufficient liquidity to cover all debt maturing in the next three years and has implemented a long-dated interest hedge, which will provide a buffer in a rising rate environment. Sales in its malls have returned to above pre-pandemic levels (exceeding the national average across all its regions) while rental income – which in Europe, is based on the inflation index – looks set to grow and management is guiding towards resuming dividends. NewRiver revised its strategy at the end of 2021, selling its former pubs portfolio to focus exclusively on retail and using the proceeds to pay down debt. Despite meaningful asset write-downs in 2020 and 2021, occupancy rates and tenant retentions remained high and steady throughout Covid – evidence of both the attractiveness of NewRiver's retail space and of strong tenant relationships. Valuations have since started to stabilise (with the valuations of core properties ticking up slightly) and rental income is back close to pre-pandemic levels. In addition, the company's balance sheet remains robust, with a low LTV of around 33%, no debt maturing in the next five years and interest rates fixed for the next five-and-a-half years.

We're comfortable to take a longer-term view

We believe that the REITs we have invested in offer a margin of safety, evidenced by their rental yields and the discounts to NAV at which their shares are trading. It is worth highlighting that these NAVs are based on property values that have been written down significantly – in many cases, to below what it would cost to rebuild the properties. Ultimately, the cycle will turn as there is no incentive to build new properties but rather to pay up for existing property. With supply becoming more constrained, vacancies should fall and rentals should increase. And as property values start to reflect these improved fundamentals, so too should REIT share prices.

I am currently renting a home and rather investing in REITs. The much unloved prices of listed property look like a stand-out opportunity to me. I expect that the cycle will turn but I'm in no rush, because I am a happy tenant and will be the recipient of a generous dividend stream from my listed property investments while I wait. And that is really why I wrote this note to our clients: please be prepared to wait with us. Our investments in property could pay off very handsomely, but it will take time.



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Operational Updates

Capensis Capital continues to benefit from the resources of Granate Asset Management. From an operational and research perspective, more minds are coming together to build the portfolio we manage. The piece above was written by Tyron Green, an analyst with many years of in depth experience into looking the opportunities and risks within the income, property and equity markets. Tyron's insights have contributed meaningfully to your portfolio, particularly over the past quarter.

Portfolio Updates

The main contributors to performance this quarter was a recovery in semiconductors and across your UK and European listed businesses. Main detractors were the property companies we have been buying and British American Tobacco.

During the quarter, we added Unibail-Rodamco-Westfield and NewRiver REIT to your portfolio as discussed above. We funded these purchases with the complete sale of First Republic Bank, as well as final sales of CTT-Correios de Portugal and Burford Capital.

First Republic Bank (FRC)

During the quarter we completely sold out of First Republic Bank. FRC has a business built on high-touch service and attractive products for high net worth individuals across select parts of the USA. This has led to a business with strong growth and an enviable credit record.

However, it has been funded with a fairly concentrated deposit base on which they historically paid little to no interest. These deposits were then lent out on long-term mortgages. There is a imbalance between the short term funding and the long term asset base as a result.

We were concerned that the interest rate trajectory in the United States could change customer behaviour and would lead to the inability of FRC to sustain its growth rates. At worst, it could lead to a run on the bank deposits which would force the bank to liquidate some of its long term assets held on the balance sheet. These assets were reported at historical cost price, not the lower prices at which it was currently trading in the market.

In our assessment, either FRC is in for a period of significantly depressed interest income or balance sheet pressure that could have some disastrous consequences.

Conclusion

It continues to be a pleasure and a privilege to manage your investment. Please do not hesitate to contact us if you have any questions regarding your portfolio.

Your partners in long-term value,

Alex, Catherine, Henno, Paul, Phila and Simone

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 31 March 2023.

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.