CAPENSIS CAPITAL

October 2023

Dear Investor,

THIRD QUARTER OF 2023

We have previously said that it is a pleasure and a privilege to manage your capital. It is actually more than that. We find purpose and motivation in the trust you have placed in us. Thank you very much for joining us on this journey.

Portfolio Updates

During the quarter we sold out of Adobe and added a new position in EOG Resources. We continue to allocate more to your investments in some of the property stocks discussed in previous letters.

The main contributors to your performance during the quarter were Howden and Markel, while the main detractors were TSMC and AIA. There is an interesting symmetry in the list of contributors and detractors with Howden and TSMC swopping places compared to the previous quarter. Furthermore, both Markel and AIA are insurance companies, with Markel benefitting from the improving non-life insurance market in the US while AIA is held back by the slow recovery in Chinese life insurance.

EOG Resources

We added the US-based oil and gas exploration and production company EOG Resources to your portfolio.

There is now an overwhelming consensus in the scientific community that the earth is warming because of human activities. To prevent severe irreversible negative impacts, we need to keep the total temperate rise to less than 2°C, and to do that we need to be capturing more greenhouse gasses than we produce by 2050 (i.e. be net zero). This means transitioning away from fossil fuels as our primary source of energy. Government policies are moving in this direction and there is pressure from shareholders, institutions and the public for energy systems to transform. Given all of this, why would we choose to invest your money in an oil company?

Firstly, let’s consider the demand side of the equation. The investment and effort required to transition to a net zero world is unprecedented. We need to phase out over 2000 coal power stations and replace them with renewables or nuclear, replace the 1.4 billion cars in the world with non-polluting equivalents, phase out the use of conventional jet fuel in aviation, electrify or modify every bit of heavy machinery that currently has a combustion engine, and replace all the carbon-based feedstocks used to produce most of the world’s plastics and other chemicals. We have solutions for some of these problems, but many of the current oil use cases are sticky. The transition requires lots of new things to be made which means lots of energy is needed, and many of these technologies face new resource constraints in things like battery metals and copper. As a result of these challenges, we think that oil will remain very relevant for at least the next few decades as we figure out how to make the transition happen in a truly sustainable and cost-effective way, especially for developing countries.

Secondly, consider the supply side. Because of the global pressure and growing awareness of ESG, major fuel companies are under pressure to downscale their operations and limit investment in new production. As a result, many companies (especially in Europe) have plans to shift away from their legacy operations. In the past, when energy prices spiked like they did post Covid, significant capex went into the industry. However, this time appears to have been different. Capex has remained muted as it has become increasingly hard for the oil majors to motivate new investment. Across most of the large European and US producers, the focus is largely the same:

very disciplined capital expenditure and a focus on free cash generation which can be returned to shareholders. The supply and demand setup thus looks reasonably healthy.

Despite this setup, there are two reasons to pause:

1. The price of oil, like any commodity, is very hard to predict
2. Oil is a messy business

It is with these concerns in mind that we picked EOG Resources out of the many oil producers. Considering point 1, to mitigate against commodity price volatility you want to invest in a low-cost producer who can easily switch production on and off. EOG has a great portfolio of high-quality assets in the Permian basin and elsewhere that can deliver many decades of profitable production at normal oil prices. They outrank all US peers in terms of the number of high-volume production wells and have total operating costs below $30/barrel. This means they can remain profitable at low oil prices and generate significant free cashflow at the current high prices. They have a successful exploration programme, deliver good returns on the capital they invest in growth, and have a track record of returning free cash to shareholders.

Considering point 2, we undertook a thorough analysis of the key ESG risks in oil and compared the US exploration and production companies on metrics such as water use, hydrocarbon spills, methane emissions, greenhouse gas emissions, biodiversity and health and safety in their operations. We also considered past controversies and lawsuits. EOG is not perfect but stood out compared to peers both in terms of improvement over the past 5 years and absolute metrics. Most notable is their proactive investment into minimising methane emissions, lower greenhouse gas intensity in their operations, significant progress in water reuse, and a good company culture.

The world needs affordable energy. It is necessary because it enables the four pillars of modern civilization: cement, steel, plastics and ammonia[1]. All human society have a desire for progress and hence an increasing hunger for these four ingredients – a hunger that grows as emerging countries develop and catch up with the developed world. We are encouraged by the research and development that is focused on solving for more environmentally friendly alternatives compared to fossil fuels, but while we wait for new solutions to solve these problems, we expect fossil fuels to remain relevant. Relevant and precariously positioned because of the global aversion to new projects and the risks that underinvestment in new energy supply pose to inflation globally.

Your portfolio now has some exposure to EOG to mitigate this risk.

Adobe

Your investment to Adobe turned out to be short-lived. We wrote about Adobe in our second quarter letter of 2022 when it was added to the portfolio. In September of 2022, the company announced that it had agreed to acquire up-and-coming Figma for $20 billion in cash and shares. Figma had projected revenues of $400m at the time, which means that Adobe agreed to pay 50 times revenue, an eye watering valuation whichever way you look at it.

In our opinion, this is a defensive act by Adobe and it caused us to question the strength of the moat and resilience of the position Adobe held with its customers. Furthermore, it is no certainty that Adobe would be able to close the transaction due to the heightened scrutiny of regulators worried about market consolidation globally.

Time will tell whether Adobe succeeds in its acquisition and integration of Figma as well as rolling it out across its client base. However, our conviction in the investment case reduced and while the share price declined

[1] For more information about the four pillars: https://time.com/6175734/reliance-on-fossil-fuels/

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materially on the announcement, our concerns about the implications of the transaction meant that we did not increase your position. Ultimately, we concluded that there are better opportunities for your capital and we completely sold your position.

Conclusion

This letter should be read in conjunction with your quarterly investment statement which contains all the financial information relevant to your account. 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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