

January 2022

Dear Investor

2021 ANNUAL LETTER

This is our fifth annual letter. We appreciate your decision to entrust your savings to Capensis Capital. Managing your money is our privilege and our passion.

Investment results

	Capensis Capital (consolidated)	Benchmark (US inflation + 6%)	Average cash holding
2017 (9 months)	+11.0%	+5.6%	64%
2018	-13.5%	+7.9%	40%
2019	+22.3%	+8.3%	24%
2020	+23.5%	+7.4%	23%
2021	+15.2%	13.0%	13%
Total	+67.0%	+49.7%	
Total annualised	+11.4% pa	+8.9% pa	

Source: Interactive Brokers, CapitalIQ, Capensis Capital

Please also review the investment statements accompanying this letter. Your individual return might differ from the returns above, depending on your starting date and some minor differences in your portfolio compared to the consolidated account.

Investment review

The portfolio performed better than the benchmark in 2021. This is a pleasing result considering the significant increase in US inflation as measured by the consumer price index.

The largest contributors to performance were your semiconductor businesses (Lam Research, Micron, Applied Materials and TSMC), First Republic Bank and Berkshire Hathaway. The main detractors were Twitter, AIA Group and Wix.com.

1. Semiconductors: Lam Research, Micron, Applied Materials and Taiwan Semiconductor Manufacturing

We have often written in [previous letters](#) about the investment case for semiconductors. As we learn more about the industry, we have developed additional conviction in the long-term investment opportunity, which we summarise as follows:

We believe that the world will continue to digitise – and this is only possible with a significant increase in the use of semiconductors. Furthermore, as more ‘work’ moves from a physical to a digital environment, more data are generated. This further increases the need for semiconductors to record, transmit, store and process data into useful information. We are very constructive on the growth outlook for the industry. Additionally, the production of semiconductors is becoming more consolidated and more capital intensive. As a result, we see value in the picks and shovels of this growing industry.

We recently wrote about the [fragility of the global supply chain](#) as it relates to semiconductors and include the piece at the end of this letter. This year started with several positive announcements on the longer-term investment plans for the industry. However, the market remains focused on the near-term reality of supply chain disruptions and pandemic lockdowns in China and other parts of Asia. We think this offers an attractive opportunity to increase exposure to some of our best ideas.

2. First Republic Bank

In a repeat of our comments of last year (and most years in its history!), First Republic managed impressive growth with very low bad debts, and showed continued progress during 2021:

- Wealth management assets increased by 44%
- Deposits increased by 36%
- Loans increased by 20%
- Total credit losses were less than 1 basis point

The bank is building on its momentum and staying within its circle of competence.

The bank recently announced that its CEO was leaving. This is an unexpected development, and we are paying particular attention to the succession process here. We are comfortable with the interim appointments while we wait for further news.

3. Berkshire Hathaway

Berkshire has been a part of your portfolio since day one.

The investment provides diversified exposure to a portfolio of steady, cash-generative assets held in a tax-beneficial structure without material overhead costs. We would not normally expect Berkshire to rank as a top-performing position in our portfolio, but we expect it to continue to provide steadily compounding value for many years to come. Berkshire (together with Exor, Markel and BAT) provides stability, which allows for the portfolio to invest in positions with more optionality like Twitter, WIX, MEI Pharma and CTT.

4. Twitter

Your investment in Twitter has not lived up to our expectations thus far. In Twitter we believe we have a healthy network that has not previously focused on monetising its potential. The company had significant technological debt and has completed a major revamp of its platform.

We are regular users of Twitter, and we continue to see improvements to the offering and new features being introduced. The tempo of innovation is showing higher cadence and it is translating into increased user engagement and healthy revenue growth.

However, while the pandemic and US political environment drove increased (and sometimes questionable) user growth in 2020, this slowed in 2021, particularly in the US. We expect a positive underlying growth trend to become more visible as the events from 2020 become less evident in the comparative base.

The company recently announced that Jack Dorsey will retire from the business and has handed over the reins to former Chief Technology Officer Parag Agrawal. By all accounts, he is a technology leader, having been involved in several of the important projects executed recently.

5. AIA Group

AIA is the largest listed Asian insurance company. The Hong Kong-listed group, which was founded over 100 years ago, operates in 18 countries. AIA has achieved very rapid growth for many years and has plenty of runway for continued growth, as the Asian market remains under-insured relative to developed Western countries.

AIA's key competitive advantage is many years of investment in distribution. It attracts the most productive brokers and ensures that they are better equipped than those at any of its competitors. During lockdowns, the group also moved quickly to ensure its brokers can continue to operate in a virtual world.

There are two particularly exciting growth opportunities for the group. The first is leveraging its distribution network to sell investment products. These products have the benefit of not requiring balance sheet reserves and therefore achieve very high returns on capital. The other significant growth opportunity is China. AIA has so far only been operating in a limited number of Chinese cities, where it has achieved rapid growth. As its license has been extended to new areas, this growth can continue.

Furthermore, AIA is very well capitalised, which means there is sufficient capital to allow continued growth in the insurance market. Importantly, AIA offers our clients exposure to the Chinese growth opportunity but without investing via the indirect Variable Interest Entity structure (about which we have reservations). We are excited about what lies ahead for AIA over the next decade.

6. Wix.com

Like Twitter, Wix has not contributed to our performance.

While the company continued its positive trajectory of subscriber and revenue growth, the market has been digesting some of the gains the company saw during the pandemic. We have kept our investments deliberately small and slow in this business, but do not think that the current valuation reflects significant positive expectations of the future.

The business of Capensis Capital

When Capensis partnered with Granate, one of the considerations was that it would give us operational and investment scale and support. Additionally, it promised to bring the dream of a global fund closer to reality. We have made good progress on the operational and investment front, and we expect 2022 to be the year in which we show progress towards launching a global fund.

We will discuss this development with you individually during the year, but we look forward to solving some of the problems that direct portfolios create for many individual investors.

Conclusion

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 for both clients and ourselves in portfolio discussions, especially when clients take opposing views.

Your long-term partners

Alex, Catherine, Henno and Paul



Disclaimer

This document is intended for the clients of Capensis Capital (Pty) Ltd. All data provided by Capensis Capital, unless otherwise stated, is current as at 31 December 2021.

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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.



THINKING LIKE ANTS:

*The investment case for
semiconductors extends
beyond chip shortages*

By Catherine Blersch

Ants are tiny creatures that alone would have very little chance of survival in a world full of dangers. Yet ants form decentralised, complex colonies that make them remarkably resilient. Take red fire ants, for example, which are native to the rainy regions of South America. When their anthills are flooded, fire ants cluster together to form massive balls that can float on top of the flood waters until they reach dry land again and form a new colony. Ant colonies can move and reform with ease – even without their queen – because they are optimised for resilience, not for efficiency. Scientists have been studying these phenomena for decades to understand how we can design more resilient systems and infrastructure in a world that is always in flux.

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FRAGILE SYSTEMS

Unfortunately, us humans don't always think like ants. Our thinking has been shaped by the industrial revolution, with its focus on intense measurement and optimisation to maximise productivity. Spurred by Toyota's famous manufacturing practices, processes like lean manufacturing and just-in-time inventory management have become the gold standard, influencing the way that global supply chains operate. Unlike ants, we are organised for efficiency, not resilience.

The problem with perfectly optimised systems, however, is that they can be very fragile. One link breaks and the whole chain crumbles. Consider what happened to global supply chains after Covid lockdowns. Instead of the system being able to adapt and form new pathways – the way ant colonies do – it became clogged up and stuck.

Nowhere has this been more apparent than with semiconductors. Take the automotive sector, for example. Manufacturers were burnt during the global financial crisis (GFC) when vehicle demand fell and stayed below peak for many years. As demand dropped during Covid lockdowns, manufacturers reacted based on their GFC experience, halting production and cancelling their semiconductor orders with the aim of protecting their balance sheets from working capital blowouts. This chip production capacity was diverted to other parts of the economy that were booming, driven by more people working and studying from home. However, Covid was not a financial crisis and vehicle demand came back strongly due to fears of using crowded public transport. When the auto companies started up again, they were pushed to the back of the chip queue. This has created a situation where relatively simple, cheap chips that usually costs a few rands are holding up the production of finished vehicles. The same is true for a wide variety of goods: PCs, tractors, Nintendo consoles... even the equipment used to make chips!



SEEING THE BIGGER PICTURE

While the chip shortage is big news and has everyone talking about semiconductors, the long-term picture is what gets us excited. We have written to you about semiconductors before, but here's a quick recap. Semiconductors, also known as chips, are the microscopic components that are packed together to form integrated circuits. They are the building blocks of all electronic equipment, driving technological advancement in all shapes and forms. Chip demand was historically driven by PC upgrades, and thus tended to be cyclical. Now, however, end markets are vast: PCs, mobile phones, electric and smart vehicles, automated manufacturing, 5G and the Internet of Things, wearable tech, robotics, machine learning and the cloud. All of this means that exponentially more data are created and need to be processed and stored. More data mean more chips and better chips. And these chips are becoming increasingly complex and expensive to create.

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COMPLEX AND EXPENSIVE TO CREATE.”

Chip shortages are noteworthy, but the tailwinds matter more. Take Micron, for example, one of only a handful of companies that makes memory chips. Memory prices declined towards the end of 2021 while inventory levels increased, prompting fears of declining end demand and the typical memory boom/bust cycle playing out. You might have noticed Micron's share price take a big dip as a result. However, our understanding is that PC (and other) manufacturers simply cannot complete finished goods because of shortages of certain non-memory chips and have had to slow their memory ordering as a result.



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With end demand still strong, this seems to have been a short-term blip and was thus an opportunity for us to be incremental buyers. Taking a long-term view, we understand the growth potential for memory to be enormous, continuing to outpace other semiconductors. We see the industry as increasingly rational, and cycles should therefore be less pronounced and more profitable than in the past. Micron is a technology leader and well positioned to capture these tailwinds.

“TAKING A LONG-TERM VIEW, WE UNDERSTAND THE GROWTH POTENTIAL FOR MEMORY TO BE ENORMOUS, CONTINUING TO OUTPACE OTHER SEMICONDUCTORS.”

THE ROLE OF AN ECOSYSTEM

Semiconductors are manufactured using a complex process of cleaning, depositing and etching extremely thin layers of material on silicon wafers that are fractions of a millimetre in size. The process is mind-bogglingly complex. This is only possible because a network of highly specialised companies works collaboratively within an ecosystem, much in the same way ants do. The creation of chips at the most advanced nodes (referred to as the leading edge) would simply not be possible if it weren't for the investments and breakthroughs in research and development by all players: equipment manufacturers like Apple that design their own chips using computing architecture developed by Arm; electronic design software providers like Cadence that allow designers to lay out and test billions of transistors; manufacturers like Taiwan Semiconductor Manufacturing Company (TSMC) that operate state-of-the-art factories that are cleaner than operating rooms; and the equipment providers like Lam Research that make each step of the manufacturing process possible. Everything must work together perfectly to do what seems (to us at least) like pure magic.



TSMC, the largest independent foundry in the world, epitomises this approach. It has never strayed from its strategy to enable rather than compete with its customers, maintaining its reputation as 'everyone's fab'. By working collaboratively on research and development with its suppliers and customers, it has stepped ahead of its two main competitors (Intel and Samsung) and is currently the only company in the world capable of producing chips at the most advanced node. TSMC's importance for existing customers is growing, and its range of customers is expanding as more companies opt to design their own chips. Its scale also makes it one of only a few companies with sufficient cash generation to spend the billions of dollars needed to build new manufacturing facilities.

BUILDING MORE RESILIENCE

One consequence of the chip shortage is that governments and end-market manufacturers are realising the importance of building resilience in the semiconductor supply chain through more local and dedicated chip capacity. TSMC, Samsung, SK Hynix, Intel and others have all announced ambitious capital expenditure plans for the coming years, and governments (including the US) are offering incentives to invest in local chip production capacity.

“WHILE NEW SUPPLY COMING ONLINE CAN THREATEN SUPPLY-DEMAND DYNAMICS IN ANY INDUSTRY, THE MITIGANT WITH CHIPS IS THAT THERE ARE EXCEPTIONALLY STRONG GROWTH VECTORS TO SUPPORT THIS.”

While new supply coming online can threaten supply-demand dynamics in any industry, the mitigant with chips is that there are exceptionally strong growth vectors to support this.





The clear winners will be the semiconductor equipment manufacturers that sell the highly specialised, complex equipment that is used to make chips. The two names in our portfolio, Applied Materials and Lam Research, are leaders in etch and deposition equipment, the largest and most important segments of the market. We like this part of the supply chain because it is consolidated, specialised, exposed to all growth vectors, and benefits regardless of whom wins the end market technology race (e.g., Intel vs TSMC, Facebook vs Google or Apple vs Qualcomm/Samsung). The outlook for equipment spending is becoming increasingly positive, setting Lam and Applied Materials up for some very good years to come.

A FUNDAMENTAL INDUSTRY WITH LONG-TERM TAILWINDS

Perhaps the most important thing the chip shortage has revealed is just how fundamental semiconductors are for the functioning of the modern economy. If you were to map out all the chips in the world it might just look like an enormous ant colony. Chips of different types and ages are scattered around the world performing the tasks they were designed for. And these chips are all connected, either via the internet or through the humans that interact with them.

While the chip shortage has created short-term profit boosts for some companies supplying in-demand chips, it has resulted in a drag for many others. We don't believe the capital investment currently planned is a short-term play that could push the industry into oversupply – that would require billions more. Instead, it's an investment that will make the whole ecosystem more resilient, enabling everyone to better harness the tailwinds to come.