

January 2023

Dear Investor

2022 ANNUAL LETTER

This is our sixth 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%
2022	-22.8%	+12.5%	8%
Total	28.9%	+68.4%	
Total annualised	+4.5% p.a.	+9.5% p.a.	

Source: Interactive Brokers, CapitalIQ, Capensis Capital

Please also review the investment statement 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.

Finding Honey Badgers

At this time of the year, one reads plenty of forecasts on what lies ahead. Commentators gaze into their crystal balls and often make compelling cases for how investments should be selected on the back of their predictions. The trouble is, predicting is very hard. It has been well demonstrated in research that the average expert's forecasts are no better than random. But while looking forwards is almost always murky, we do believe there is value in looking backwards.

In March of 2020, we were placed into lockdown and lived with varying levels of restrictions for the next 24 months. In July of 2021, riots sparked in South Africa where looting caused damage to businesses, infrastructure, and confidence in our government's commitment to enforce the rule of law. Further afield, we witnessed a mob attack on the United States Capitol Building, the UK lived through the shortest ever tenure for a Prime Minister, war erupted in Ukraine and precipitated a global wave of high inflation, and central banks globally responded with rapid interest rate hikes.

These adverse events had tragic consequences for many - uncertainty, losses of lives and livelihoods, and daily hardship. There were negative impacts on both government fiscus and the private sector, affecting their ability to service debt. Business owners were forced to reduce wages and cut staff - and for many, the hard knocks to profitability meant they had to close their doors. More recently, spiking inflation combined with higher interest rates placed additional pressure on both consumers and businesses. If we knew about all these developments in advance, would we have been brave enough to invest in anything other than cash? The most likely answer is no.

We believe that the odds of making good investments are far better when you consider present certainties rather than forward-looking assumptions. Honey badgers are considerably tougher creatures than Maltese poodles. We don't need to know the future to know that if we left the two roaming in the wild, the odds of survival for the former are multiples higher than for the latter. Like the bush, the free market is and will remain brutal. When investing in an entity's shares or debt, we try to work out if it is equipped for survival in the wild. How exactly do we determine if an entity is a honey badger or a Maltese poodle?

We look at the track record of the people involved and how they are incentivised, the strength of internal governance processes, the robustness of the balance sheet, the competitive advantage of the business and, ultimately, whether the business produces free cash flow. If we do manage to find what we are looking for, we need to curb our enthusiasm to make sure that we don't overpay for equities and are adequately compensated for debt instruments. Nobody knows the exact value of an instrument, but you can work out how excited other people are about it. When performing valuations, we try to minimise our reliance on forecasting and exact outcomes. Instead, we focus on the certainty of emotions in prices. We try to evaluate if the current price reflects fear of missing out or fear of losing money. We prefer to invest in the latter.

What lies ahead for 2023?

We prefer not knowing because it might prevent us from buying honey badgers at good prices. We have tried to build portfolios that are fit for a wild, uncertain world so that we can watch the future unfold with interest rather than anxiety. We would like to encourage you to think the same about your investments with us.



Investment review

The portfolio lagged the benchmark in 2022. While we are disappointed in the returns over this 12-month period, we remain excited about the intrinsic potential of the portfolio.

The largest contributors to performance were Twitter, British American Tobacco and your insurance conglomerates (Markel, Berkshire Hathaway and AIA). The main detractors were your semiconductor businesses and MEI Pharma.

1. Twitter

We discussed your investment in Twitter in our [second quarter letter of 2022](#).

We sold your position in Twitter following the buy-out offer made by Elon Musk. At that time, we had limited confidence in the deal actually closing. Ultimately, Musk completed the purchase and is now running the company in parallel to his numerous other business interests.

As a result of the take-over premium offered by Musk, Twitter was the largest positive contributor to the portfolio performance in 2022.

2. British American Tobacco

BAT performed as we would have hoped for in chaotic times. It is a defensive business generating high levels of cash flow and pays an attractive dividend to shareholders. During the past year, the company also restarted a share buyback programme, further increasing the return to shareholders as we regard the current price as below our estimate of fair value.

Exposure to BAT and certain other defensive positions provide a ballast to the portfolio which tend to show their value in difficult markets. We don't expect these companies to compound at aggressive rates, but to continue to compound through out the complete business cycle.

3. Insurance conglomerates: Berkshire Hathaway, Markel and AIA

Another group of companies that delivered a positive return was the insurance conglomerates. These businesses then to be positively correlated to interest rates as they generally have large amounts of cash and low-risk investments that can benefit from rising interest rates.

Furthermore, all three these businesses were active in repurchasing their own stock when the market offered opportunities.

In terms of overall risk and growth potential, we regard Berkshire as the gold standard that could generate returns close to 10% p.a. for many years to come. Markel has some higher ambition to grow its insurance business by closer to 15% p.a. while AIA has an enormous run-way to benefit from insurance penetration across Asia and in particular in China and India.

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

This past year saw a turnaround in the contribution from your semiconductor investments. This follows three years of strong performance from the previous cyclical bottom, but 2022 reminded us that semiconductors remain a cyclical industry and that cycles can be exacerbated by disruptions caused by a global pandemic.

Having said that, we remain steadfast in our conviction in the long-term potential of this group of companies. We used the weak share prices to increase your exposure, in particular to TSMC where we think we've found a real honey badger.

5. MEI Pharma

The biggest single detractor was MEI Pharma. We started the year with a lot of optimism following the phase 2 clinical data released by the company in the end of 2021. However, early in 2022, the company announced that the FDA closed the door on accelerated approval of MEI's blood cancer therapy, zandelisib. We understood that this meant that there will be a delay before revenues could be earned as MEI had to complete a phase 3 study first. This study was already started at the time and the FDA encouraged continued research.

In November 2022 the company announced that following further discussions with the FDA they concluded that the phase 3 study no longer met its commercial considerations and MEI ended the study early. This was incredibly disappointing news, but not unique in the world of pharmaceutical research.

Your initial exposure to MEI was deliberately kept low, but the strong growth delivered to 2021 meant that you had significant unrealised gains from the investment heading into 2022. The subsequent share price collapse turned that unrealised gain into a loss.

Where do we stand now? The company announced that they are embarking on a strategic review suggesting that a sale of the business is a possibility. Currently, the market capitalisation of the company is less than the cash on the balance sheet and hence we see no reason to sell the shares – liquidation would deliver more than selling in the market. We believe there is value in the rest of the portfolio and believe that management remains committed and incentivised to maximise shareholder value.

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. Last year we wrote to you that we are making progress towards launching a global fund. Unfortunately, some of our plans failed to materialise and we are still exactly where we stood a year ago. We hope to show more progress during 2023 in this regard.

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 us in portfolio discussions, especially when clients take opposing views.

Your long-term partners

Alex, Catherine, Henno, Paul, Philasande and Simone



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 2022.

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

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