CAPENSIS CAPITAL

January 2020

Dear Investor

2019 ANNUAL LETTER

This is our third annual letter to investors and it's our privilege to provide some feedback on your investment with Capensis Capital.

We started managing individual accounts at the beginning of April 2017. This letter covers the performance since that date. This is a short period in the markets and, as explained in my introductory letter, the business is on a multi-decade journey. The aim remains to outperform US inflation plus 6% per year.

Investment results

	Capensis Capital (consolidated)	Benchmark (US inflation + 6%)	Average cash holding
2017 (9 months, from April)	+11.0%	+5.6%	64%
2018	-13.5%	+7.9%	40%
2019	+22.3%	+8.3%	24%
Total	**+17.4%**	**+23.3%**	
Total annualised	**+6.0%**	**+7.9%**	

Source: Interactive Brokers, CapitalIQ, Capensis Capital

Please also review the investment statements that I'm sending with 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 2019. This is a pleasing improvement from 2018, but we realise there is always more work to be done.

The main contributors to performance were Brookfield Asset Management, Lam Research and RIB Software. The main detractor was Burford Capital. We exited our positions in Teekay Offshore and Partners Value during the year.

All these companies were discussed in previous letters. I invite you to review the investment cases.

1. Brookfield Asset Management (BAM) and Partners Value Investments (PVI)

BAM and PVI started the year as your largest equity exposure and contributed the most to the growth in the portfolio in 2019. (As a reminder, PVI is an indirect way to own more BAM.

BAM is one of the leading managers of alternative assets (property, infrastructure, renewable energy and private equity) and continues to benefit from the tailwinds created by the low yields available on safe assets globally. If rates remain low, this growth in assets under management is likely to continue, as capital allocators invest more money into alternative strategies. On the other hand, BAM is sensitive to increasing rates, which will affect both the valuations of its investments on the balance sheet and its ability to raise capital for its funds.

The share price of BAM increased by more than 50% in 2019 and the margin of safety has reduced. We lowered your investment in the business by reducing exposure to BAM and selling out of PVI.

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2. Lam Research (LRCX)

Your investment in LRCX was your best performer in 2019, as the share price more than doubled. As we explained previously, we thought the market was myopic in its focus on short-term cycles and missed the secular growth underpinning the demand for the equipment LRCX manufactures.

Management at LRCX seemed to agree, by repurchasing shares. This reduced the share count by nearly 10% in 2019. We regard this as encouraging capital allocation, both in timing and execution.

LRCX is currently very well positioned for the upturn in the semiconductor equipment market. Perhaps more importantly, the equipment that LRCX develops and sells is becoming increasingly relevant to semiconductor manufacturers. We don't think we have seen the full potential of the secular growth in data and processing and have maintained your position in LRCX.

3. RIB Software (RIB)

We are pleased to report that RIB is on the list of top performers for 2019, with a return of around 90%.

You might remember that it was one of the main detractors last year, and in our 2018 annual letter we discussed that it would be a few years before the full investment case plays out. This remains true. We see an asymmetric long-term investment case, but short-term share price movements could remain volatile as the business transitions to a cloud enterprise.

4. Teekay Offshore (TOO)

TOO offers less to celebrate. As we discussed in our Q2 2019 letter, the business was the subject of a take-under offer by BAM. The final price amounted to $1.55 per unit, a gain on your holding of around 17% for the year. However, we lost money over the full term on our investment in TOO.

We learnt a hard lesson from this experience: we were limited partners in TOO – not shareholders – and I (Henno) did not fully appreciate how easily the economic potential of our investment could be taken away by a general partner. We received around 40% of what we regard as the fair value of TOO. What is more disappointing is that we will not be able to participate in any future success of the business.

5. Burford Capital (BUR)

The biggest disappointment in 2019 was BUR. We invested in BUR at the start of 2019 and, as detailed in our Q3 2019 letter, the company was the target of a short attack in August. The attack was extremely successful in sowing doubt about the sustainability of BUR and its investment returns. We think the allegations levelled against BUR were sensational and carefully crafted to create panic. But, as we discussed in other letters, the fact that the prices of BUR's debt and equity fell (and remain low) means that the cost of funding future litigation investments has increased. This reduces the intrinsic value of BUR.

You are still invested in BUR, albeit with a reduced shareholding. We approve of the changes that management implemented in strengthening the business and the governance structures.

Portfolio updates

1. Cash

Cash remains the largest single holding in the portfolio. As previously explained, cash is our default position. We allocate from cash as-and-when we find investment opportunities matching our specific investment criteria. Your cash position will fluctuate with the purchase and sale of individual securities, and not according to a predetermined target level.

Additionally, we expect the portfolio to have cash available most of the time. The account is managed according to a flexible mandate, which means that we are not bound to being fully invested. Cash adds resilience during market downturns and the ability to act quickly when opportunities arise.

2. MEI Pharma (MEIP)

A new holding purchased during the last quarter is MEIP.

MEIP is a small pharmaceutical company focused on oncology research. Currently, there are four drug candidates in various stages of clinical development. Three of these are aimed at related blood cancers, while the fourth has a more general oncology application.

So why does MEIP offer value?

MEIP seems to be a smart investor within the pharma space, identifying value in areas discarded by other firms. The management team is a group of extremely accomplished individuals:

- Chief Medical Officer Robert Mass was responsible for the development of three blockbuster drugs while at Genentech (Tarceva, Avastin and Herceptin). Genentech is now part of Roche.
- Chairman Christine White was involved in the commercialisation of another blockbuster, Rituxan – now also part of Roche's portfolio.
- CEO Daniel Gold joined the business in 2010 and proceeded to completely change the direction of the business.

The management team is extremely successful in developing clinical trials that deliver results at a fraction of the normal expense.

Looking at the science, MEIP's drug candidates show impressive potential in being more efficient and more tolerable than current approved products. There are also trials testing the candidates in combination with other compounds, which show promise.

By our calculations, MEIP will be a successful investment if any one of the four current candidates succeed in their clinical trials. We expect 2020 to be the year in which one or more of the results are announced.

Soon after we invested in MEIP, the company announced a capital raise and we were able to increase your investment at an attractive price. The additional capital raised increases the longevity of the business and the likelihood of success.

The business of Capensis Capital

2019 was transformational for the business, as we discussed in a previous letter.

Capensis welcomed Paul Bosman as a partner and we then joined forces with Granate Asset Management. Capensis is now a subsidiary of Granate and we will soon be launching two new local unit trusts: a flexible fund and a balanced fund. Ultimately, the final step in the process will be to launch a global fund and to convert individual accounts into units in this fund. We will be in contact once we have enough scale to consider the conversion.

We have also moved into a new office in Josephine Mill, in the shade of the Newlands rugby stadium. Please feel free to visit us when you are in need of good coffee.

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 a lot of value in discussions about your portfolio and it remains most important to tell us if there is anything you disagree with.

Your partners in long-term value,

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 2019.

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

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

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