CAPENSIS CAPITAL

January 2019

Dear Investor,

2018 ANNUAL LETTER

This is my[1] second annual letter to investors and it's my privilege to provide some feedback on your investment with Capensis Capital.

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

Investment Results

	Capensis Capital (Consolidated)	Benchmark (US Inflation + 6%)	Average Cash Holding
2017 (9 months, April – Dec)	11.0%	5.6%	64%
2018	-13.5%	7.9%	40%
Total	**-4.0%**	**13.9%**	
Total annualised	**-2.3%**	**7.7%**	

Source: Interactive Brokers, Reuters, Capensis Capital.

Please also review the investment statement 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 underperformed the benchmark in 2018. This is a disappointing result, but as I discussed in my previous letter, declining markets are a normal part of the investment cycle. During the year I added new businesses to the portfolio and increased exposure to equities to around 75%. The past quarter saw the most activity in the portfolio to date.

My aim with the portfolio is to invest in a group of businesses that will enable your capital to compound at attractive rates for many years. In doing so, I try to identify businesses that have sustainable business models, trustworthy management teams, long runways for growth and share prices that are trading below my estimate of the intrinsic value.

I plan to hold these businesses while the market prices remain lower than what I regard as fairly valued. I will sell when they become expensive, upon the realisation that I made a mistake, or when I identify more attractive opportunities. However, I realise that the structure in which I manage these portfolios may not be tax efficient, so any transaction will be made after consideration of the tax implications. In my introductory letter, I discussed the planned progression to a global fund that would

[1] I am using the pronouns "I", "me" and "my" in this letter. It is currently correct as I am the only shareholder, director and employee, but as I explain later in this letter this will likely change during 2019.

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improve the tax efficiency in the future. Certain events in 2018 have placed additional focus on the plan.

During the year, two companies traded close to the price that I regarded as fair value. L Brands and RIB Software increased significantly from the levels at which I made your initial purchases. However, their share prices failed to reach the prices at which I was ready to completely exit the positions. Thereafter, both declined through the balance of the year. In fact, they went from two of the main contributors to performance to two of the laggards during the year. Clearly, I made a mistake by being overly tax-sensitive to crystallise profits.

In the future two changes will be made. Firstly, I will begin to reduce as market prices approach fair value (as opposed to waiting for one price to exit completely). While this will possibly cause some capital gains to be triggered earlier, it will lead to better outcomes than seen in 2018. Secondly, the plan to grow the business and launch a fund is receiving more attention. More about this later in the letter.

The main detractors to performance were L Brands, Teekay Offshore and RIB Software, while the stand-out performer was Genworth Financial. All these companies were discussed in previous letters. I invite you to review the investment cases.

1. ***L Brands (LB)***

The market continues to focus on the difficulty in the lingerie section of LB's business where the Victoria's Secret and Pink brands are under pressure. The turnaround is taking longer than anticipated and the company responded by changing management and exiting loss-making brands. The company also made it clear they are reviewing all elements of the business, including reversing some of the own-goals they scored over the past few years. I think it is fair to say that the results reported during 2018 failed to live up to the positive anticipation the business ended 2017 with.

On the other side of the business, Bath and Body Works is firing on all cylinders and now accounts for the majority of the profit in the group. It seems that the market is oblivious to the performance delivered by both the online and the brick-and-mortar distribution channels.

LB is a business that I am keeping a close eye on. I think that BBW accounts for the full value of the share price and no value is attributed to the lingerie side. Such low expectations should do well to create value for patient investors.

2. ***RIB Software (RIB)***

RIB is perhaps the business with the most asymmetrical potential payoff in the portfolio but it will be a few years before it is realised. The business is continuing on its process to transform from an enterprise software developer for the construction industry into a modern subscription business offering both software as a service (SaaS) and a procurement platform.

At the end of the first quarter, RIB made use of the steep increase in share price to raise capital from institutional investors. Unfortunately, my previously discussed tax-sensitive foolishness meant that the subsequent decline in share price wiped out your gains to that point in time. However, the justification for the capital raise was to fund the development of a managed service provider network

to roll out the SaaS version of RIB's software with Microsoft as its partner. This has increased the potential market for RIB drastically as smaller contractors can now afford the subscription.

During the last quarter, the share price fell significantly after RIB announced that they have purchased the remaining stake in the joint venture with Flex. Flex had a very disappointing year and had an unexpected change of leadership. Apparently, the price RIB paid for Flex's interest was much lower than expected and some analysts extrapolated that lower figure to the whole venture. This strikes me as odd, as I think management might have taken advantage of their partner's decision to exit this particular investment and was able to negotiate a low purchase price. Ultimately, the potential value of the venture was not dependent on Flex, as RIB has added other partners to the platform and continue to do so. Management responded to the price decline by instituting a share buy-back programme. Time will tell whether management or the market reaction was correct.

RIB ended the year without any debt and with cash amounting to approximately half of the market capitalisation. Your ownership of RIB increased during the year.

3. *Teekay Offshore (TOO)*

TOO was added to the portfolio during 2018. It provides the floating infrastructure that enables offshore oil drillers to deliver oil to the mainland where pipelines are not possible. It operates mainly in the North Sea, Canada and Brazil.

The share price fell during the final quarter of the year and ended the year around 50% below the price at which Brookfield Business Partners acquired control of the business. The share price decline does not make sense to me. It coincided with the general market turmoil, the oil price decline and a change of sentiment towards oil services providers, particularly the small caps. However, TOO takes very little direct oil price exposure and management has become increasingly positive on the opportunities they see in the market. There is a strong case to be made that offshore drilling should increase as the large oil companies struggle to replace their current production.

Because TOO has a limited free float (I saw estimates of only around seven per cent of the issued shares) and its history of a broken income investment, there were clearly few buyers during the fourth quarter of 2018. On relatively small daily trades, the share halved without any underlying justification that I could find. I increased your holding in TOO during November and December.

4. *Genworth Financial (GNW)*

Your investment in GNW should be classified as a special situation. To recap, in October 2016 the company agreed to be acquired by China Oceanwide Holdings Group at a price of $5.43 per share. There were numerous regulatory approvals necessary for the deal and the closing of the deal was repeatedly delayed as a result.

By October 2017, the shares were trading around 35% discount to the agreed price. This implied more than 50% upside if the deal were to close. The parties still needed approval from regulators in the US, Canada, Australia and China. Specifically, the approval from the Committee on Foreign Investment in the United States (CFIUS) was required at a time during which the Trump administration and the Chinese government started their trade wars.

My analysis suggested that the deal made economic sense and that there were no real national security concerns surrounding the deal. Furthermore, it seemed that the base rate for successful deals of this nature was around 70%. Basically, the risk of the deal not proceeding was already priced in and the downside seemed limited.

During the past year, GNW proceeded in getting CFIUS approval and thereafter the individual state regulators also approved the deal. By January 2019, all US approvals were received, and the shares traded closer to the agreed price. I sold some of your holdings in GNW after year end.

Portfolio Updates

1. ***Cash***

Cash remains the largest single holding in the portfolio. As previously explained, cash is my default position: the cash level is determined by the opportunities that I have found for investment. Our cash position will fluctuate with the purchase and sale of securities. I do not specify a target cash level for the portfolio.

I expect the portfolio to have some cash available most of the time. The mandate, according to which I manage the accounts, is a flexible one. In other words, I am not bound to be fully invested. Having cash adds resilience during difficult times and the ability to act quickly when opportunities arise.

2. ***Interactive Brokers (IB)***

IB is the stockbroker I use to manage your account and you should have seen the name on the statements that accompany these letters. However, IB should actually be classified as a technology company. Specifically, IB is a company that automates tasks, choosing to focus on automating the business of electronic brokerage.

The business traces its origins to computer programmer, Thomas Peterffy, who in 1977 became a market maker on the American Stock Exchange. His programming background allowed him to develop the largest electronic options market maker, Timber Hill, utilising technology in a way that was ahead of its peers. The business delivered on the promise of fast and easy access to markets, very low transaction costs and the best execution of trades. In addition, it offered an efficient back office with zero custody fees, low margin rates, high interest rates on cash and the availability of shares for derivative transactions.

In 1983, IB launched its brokerage business utilising the tools it built as a market maker. All these professional services are available to you on Interactive Brokers. It has democratised the systems required to manage investments globally. In addition, IB no longer makes markets in options focusing purely on improving the electronic brokerage it has built. This scale was developed by automating the business of electronic trading as far as possible. In fact, most senior managers are software engineers.

IB is currently the largest broker by trade volume globally and also the lowest cost provider in the market. Interestingly, despite being the cost leader, it also has the highest margins and the highest return on client assets compared to peers. It is growing at very attractive rates. Client accounts increased by 24% in 2018.

The business has no debt and has $7 billion in shareholder capital, $5.5 billion of which is additional capital it holds above regulatory requirements. The founder-chairman owns approximately 73% of the

company and has more than $16 billion exposure to this business. I am very comfortable to be a client of this business.

The Business of Capensis Capital

A total of 40 friends and family members currently have accounts managed by Capensis Capital. Assets under management amount to $4.4 million. The business is nearly sustainable, but not large enough to progress to the next intended step of a launching a fund. As a result, I intend to expand the business during 2019 which might include inviting more people to join me in managing your investments. These discussions have started and I will keep you updated on any changes in this regard. Please reach out to me if you are aware of anyone you would like to recommend to Capensis Capital.

Conclusion

It continues to be a pleasure and a privilege to manage your capital. As always, I invite you to contact me if there is anything you would like to discuss. I find a lot of value in discussions about your portfolio and it remains most important to tell me if there is anything you disagree with.

Your partner in long-term value,

Henno

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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 2018.

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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.