CAPENSIS CAPITAL

July 2017

Dear investor,

SECOND QUARTER OF 2017

My primary communication with investors is the annual letter. However, I plan to use quarterly updates to introduce new holdings added to the portfolio and to discuss any other updates to the business of Capensis. These quarterly updates will be extensive during the initial quarters, as I add new holdings to the portfolio. With these updates, I'll explain the reasoning behind the purchase of the investments that are now included in your portfolio.

Please read this letter in combination with the quarterly statement of your investment as the statement contains all the financial information relevant to your account. I invite you to contact me if you'd like to discuss the holdings further or disagree with anything I have written.

Operational Update

I want to begin by thanking you and your families for your decision to partner with me in this venture. It is a privilege to know that you have entrusted me with your savings during the beginning stages of this journey.

I released my introductory letter to friends and family in April and received a lot of feedback and interested calls as a result. Thank you to everyone who forwarded the letter to a wider audience. The level of interest is encouraging for this new venture.

However, the time required to meet, engage, and sign up new investors is more than I expected. I have decided to limit the number of accounts that I will manage during this first phase of the business to around 50, or less, if the business reaches a financially sustainable level sooner (we are currently approximately halfway to either target). Thereafter, I will reopen to new investors once the offshore fund has been launched.

A question that is frequently asked is what will happen to your investment if something disastrous were to happen to me. The bad news is that succession planning for Capensis is still a few years off (neither of my daughters has started reading annual reports and no one has offered to work for a negative salary without benefits). The good news is that your investment is in your own name and you always have access to it, irrespective of whether I'm around or not. If I were no longer able to manage your account, you have three options:

1. Liquidate your portfolio and invest your money elsewhere
2. Transfer your account to another portfolio manager to administer the account on your behalf
3. Begin managing the account yourself

I am happy to discuss these options with you if you are interested.

Portfolio Updates

1. Cash

Cash is currently the largest holding position in the portfolios. It is my default position and the level of cash is a result of the opportunities that I have found for investment. The cash position will reduce as more securities are purchased and increase as securities are sold. The level of cash is not something I target specifically.

Additionally, I expect the portfolios 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 forced to be fully invested). Having cash adds resilience during difficult times and the ability to act quickly when opportunities arise.

I do not feel pressured to rush into the market and invest all capital during periods where markets hit all-time highs. (And with that sentence I have also completed the macro overview for the quarter).

2. *State National Companies (SNC)*

SNC is a niche insurance company based in Texas. It currently operates two lines of business: Portfolio Protection and Insurance Fronting. This is a family managed company that was founded 1973 by the Ledbetter brothers, who built the business to its current form. The business was listed in 2014. Terry Ledbetter remains CEO (his brother Lonnie retired before the listing) and family members own approximately 28% of the business.

The business is not large, with a market cap of $775m, and is not widely followed. I think it makes a compelling investment opportunity, but also offers interesting portfolio diversification as I explain below.

From 2013 to 2016, SNC grew revenues by 20% per annum and earned an average ROE above 16% while taking on limited investment and underwriting risk. Fee-based earnings delivered 70% of pre-tax income in 2016.

Portfolio Protection

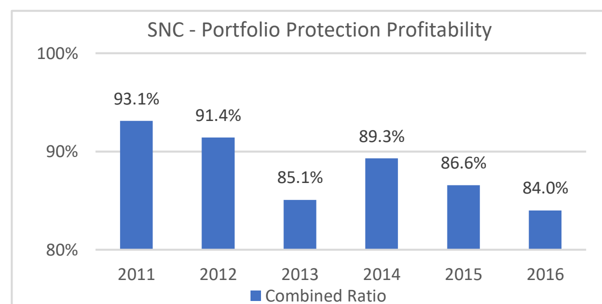
The smaller area of business is Portfolio Protection. SNC provides a form of automobile insurance that protects the collateral of the lender rather than the driver. When a vehicle is purchased on credit, the credit provider requires the borrower to purchase comprehensive auto insurance on the vehicle. If the driver fails to maintain this insurance, SNC automatically writes a policy for the required coverage and the premium is added to the monthly loan repayment amount.

SNC offers a fully vertically integrated service, from tracking the loans to issuing policies and administering claims. In this line of business, the price is less important than the quality of service and SNC's InsurTrak system offers a competitive advantage. Clients are mainly credit unions and SNC, together with two other companies, account for approximately 70% of this market segment. SNC has a long-term arrangement with CUNA, a national association, which allows SNC access to nearly all credit unions and the company provides its technology to more than 600 customers allowing it to track approximately 6.4m auto loans.

Much has been written about the state of the US auto finance market and certain warning lights are showing. However, the credit unions tend to attract a high-quality client base and SNC has a counter-cyclical exposure to the market as it only writes policies where contracted coverage is not taken out or cancelled. SNC's insurance penetration of the loans it tracks is below historical levels and it stands to benefit as borrowers lapse on their conventional auto insurance policies – something that often happens during times of financial strain.

I was taught that the only good insurance is profitable insurance and an important question to ask is whether SNC writes good insurance policies?

Historical evidence suggests a strong yes. SNC delivered an average combined ratio of below 90% from 2011 to 2016. This means that the business retains more than 10% of paid premiums as profit, a very attractive result considering that the auto insurance industry often struggles to show underwriting profits. The long-term target is to maintain a combined ratio of 85% to 90%.



Insurance Fronting

In the second area of business, Insurance Fronting, SNC enables other businesses to write insurance policies. Before anyone can write insurance policies in the US, they must be licensed and licenses are regulated by individual states. Additionally, a strong credit rating is normally required before clients will do business with an insurance carrier. SNC is licensed across the US and has a high credit rating that it "rents out" to other businesses enabling them to write insurance policies in return for a fee.

Essentially, SNC brings together the capital providers willing to take on insurance risk with clients looking to insure their risks. SNC does not participate in insurance risks as the traditional insurance companies do. SNC's participation transfers all insurance risks back to the capital providers, such as reinsurance and foreign insurance companies, large corporations, as well as other alternative capital providers, including hedge funds.

The main risk to SNC is that one of these capital providers fails to settle its claim liabilities. SNC's expertise lies in the selection of the capital providers they do business with and ensuring sufficient collateral is held to cover claims on the policies. Over the past four decades, the company has written more than $13bn of these contracts, without a failure.

Insurance Fronting contributes more than double the profit of Portfolio Protection and it is also an area with strong growth potential. While other insurance companies lament additional capital entering the insurance market (as it drives down profitability), SNC is growing its presence as the provider of "picks and shovels" in the insurance market. Current estimates are that alternative capital is set to double in the medium term while the traditional capital remains broadly stable. SNC stands to benefit from the growing supply of non-traditional players and is not exposed to the overall profitability of the market.

SNC's market share in Insurance Fronting is estimated at 2.5% and the company is highly regarded for its independence and its record of accomplishment in this fragmented market.

The Future

The company has invested in additional operational capacity over the past few years. This has enabled SNC to market itself more actively among small and medium enterprises. These investments are showing some encouraging results in diversifying its historically concentrated client base.

SNC is a growing business with a compelling investment case that also offers diversification against the obvious risks in auto finance and the influx of capital to reinsurance markets. There are significant growth opportunities in Insurance Fronting while Portfolio Protection remains very profitable. SNC earned 17.5% ROE in 2016 and it is quite possible that this figure will increase over time.

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3. *Howden Joinery Group (HWDN)*

Howdens manufactures and sells kitchens to small builders and kitchen fitters. It is the largest supplier of kitchen cabinets in the UK and accounts for approximately a quarter of the overall market. The kitchen market is split between DIY and DFY (Done For You) participants and Howdens is firmly in the lead in the DFY market.

Howdens is a participant in two strong trends: The increasing importance of kitchens in the modern home and the move away from DIY efforts to DFY projects. The first creates demand for the upgrading of kitchens and the second moves demand towards Howdens.

The business started in 1995 as a division of the furniture retailer, MFI. The idea was novel: start a business that is wholly focused on the small-contractor and design the business around their needs. As a result, the business has a strong competitive advantage in the way that it solves the working capital requirements of contractors. Howdens provides both the inventory (always available at local depots) and payment terms that ease the contractor's cash flow cycle. Additionally, Howdens also offers design services to plan the new kitchen layout.

The business model works well and no competitor has replicated the offering. Being the largest in the market also affords some economies of scale that allow Howdens to have a wider variety and lower prices than its peers.

Howdens has around 650 depots in the UK and sees growth potential to 800 depots. The unit economics of a depot is very attractive as the company combines relatively low capital intensity with attractive margins. This leads to a group with a high return on invested capital (ROIC) which, even when adjusted for the fact that they lease their depots, is significantly above 20%.

The business has expanded into select European territories, mainly in France, but also in Belgium, the Netherlands, and Germany. At this stage, they are still evaluating the current European operations before a final call is made for any additional European expansion. This is one example of thorough expansion planning.

Another example is the amount of capital expenditure the business makes for future growth. As they have identified the potential to open as many as 800 depots across the UK, the company has invested in upgrading the manufacturing and logistics infrastructure and the distribution centre required for the future. This has a negative effect on current profitability but bodes well for the future as capacity utilisation increases.

The culture in the company seems very healthy. Depots are operated by managers with a high level of autonomy and staff members are incentivised on local results. The current CEO, Matthew Ingle, is the founder of the business. He has recently indicated that he will retire (but remain a board member) and will be succeeded by Andrew Livingston. Andrew joins the company from Kingfisher plc, where he very successfully managed the Screwfix division – the featured division within a business that is executing a transformation plan. This seems like a sensible hire as Screwfix successfully developed an e-commerce offering to the trade market and expanded into Europe.

Howdens has skilfully navigated several crises during its history. When its parent company failed in 2008, Howdens was saddled with debt, onerous leases, and a pension deficit it inherited from MFI. Soon afterwards, the global financial crisis struck. Despite these headwinds, Howdens largely solved these problems while growing and remaining invested in the future.

Howdens is exposed to spending on repairs, maintenance, and improvement of UK housing and there is no doubt that Brexit will have an effect in the near term (which will likely affect the share price as well). However, I am excited about this business because of its strong economic moat, market positioning, and financial stability. It generates very high levels of cash and Howdens will likely emerge stronger than its competitors and provide an attractive opportunity for investors with a suitable investment horizon.

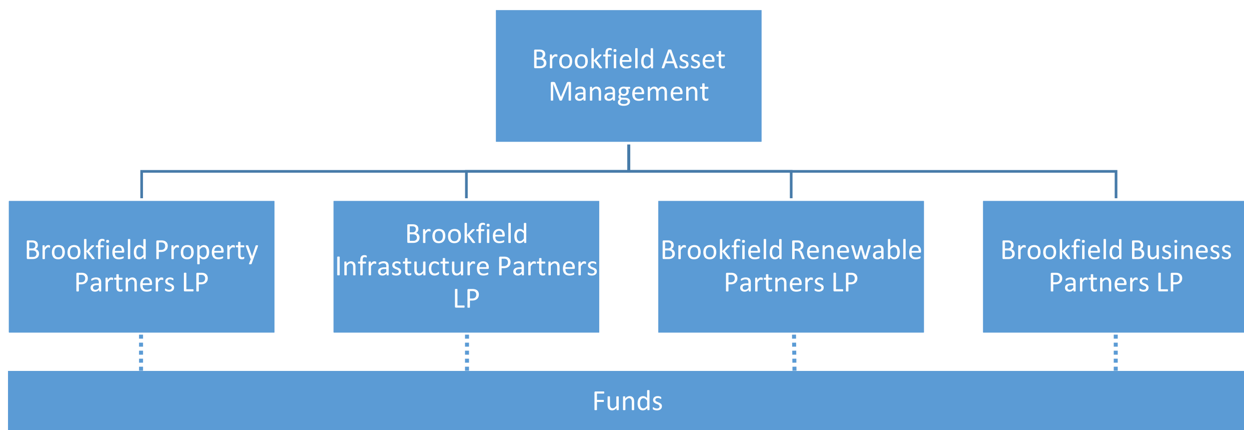
I expect Howdens to double its free cash flow over the next five years.

4. *Brookfield Asset Management (BAM)*

Brookfield is the second largest manager of real assets in the world. The company has Canadian and Brazilian roots and has been in existence for more than 100 years. However, it still flies below the radar compared to its more widely known peers.

BAM has around $250bn of assets under management, earns fees on more than $110bn in capital and has operations in more than 30 countries. This is a large business. It follows a long-term, value based, and often contrarian investment strategy in the fields of property, infrastructure, renewables, and private equity.

Asset management is a business with attractive economics. However, the fickle nature of assets under management can create friction between long-term thinking and short-term motivation within manager. BAM has an enviable corporate structure. The company controls four listed partnerships, which provide it with permanent capital to invest. The listed partnerships also act as anchor investors in the funds managed by BAM. The funds are very stable with fund cycles of seven to twelve years.



The business model, as explained by the company, is simple and repeatable:

1. *Source equity from clients seeking exposure to property and infrastructure returns*
2. *Use their access to large scale capital to invest on behalf of clients*
3. *Utilise their global reach to identify and acquire high-quality Real Assets*
4. *Finance assets on a long-term, low-risk basis*
5. *Enhance the cash flows and value of assets by leveraging their leading operating businesses*

BAM has some competitive advantages in this regard. As described above, the capital it manages is long-term in nature and the company's absolute size enables it to participate in larger transactions where fewer competitors operate.

It has a proven track record of delivering attractive returns by both investing in the right assets and operating these assets efficiently. Additionally, it has shown itself to be shrewd in taking advantage of opportunities that the market delivers.

Another advantage lies in BAM's positioning in the current investment environment. The dearth of investment opportunities in fixed income globally has encouraged large capital pools to increase their allocation to other assets. Equities have been an obvious beneficiary of this, but so too is the increasing allocation to real assets. BAM is one of the preferred asset managers in this regard and the size and speed of its latest fund-raising series are evidence of the market's willingness to invest with BAM. I think this change in asset allocation towards real assets is a structural change in the mindset of sovereign and institutional funds. Furthermore, should the yields on fixed income markets continue to remain unattractive, the allocation change is set to increase even more.

While I regard BAM as an attractive stand-alone investment, it also enhances the portfolio if rates remain lower for longer.

The business is led by a competent management team with substantial personal investment in the Company. The CEO, Bruce Flatt, has recently been profiled in Forbes magazine. Please read the article as the prose is much better than mine.

6. Berkshire Hathaway (BRK)

The final stock I'd like to discuss this quarter is Berkshire Hathaway. I'm sure that the business is well known to most readers, not only for its long-time CEO, Warren Buffett, but also for the incredible investment returns it has generated for more than 50 years.

It is true that the business is no longer going to grow at the near 20% it has since 1965. When asked at this year's annual shareholder's meeting what the intrinsic growth potential of Berkshire might be, Buffett answered that he thought it possible that Berkshire could compound at 10% per annum. But he added that this might require a normalisation of interest rates to a higher level than current.

Up to 10% annual growth does not sound earth shattering. However, by my estimation, the business is trading at a discount to intrinsic value and this allows for enhanced investment returns if the share price approaches fair value. In a sense, I see Berkshire as enhanced cash – a low risk, growing investment.

The main attraction in Berkshire is that it affords the opportunity to buy into a conglomerate of mainly American businesses that are very diverse, have strong market positions, and are incredibly stable as a whole. Berkshire is no longer an insurance company with a public equity portfolio. The Berkshire of today owns entire businesses including insurance, railways, regulated energy utilities, and a very wide range of manufacturing, retailing, and services operations. It produces billions of dollars in cash flow every year and its balance sheet is exceptionally strong.

The business has an attractive culture of decentralised decision-making. Management teams of underlying businesses are free to run their business in their own way. The primary direct instructions they get from head office include protecting Berkshire's reputation: "We can afford to lose money – even a lot of money. But we can't afford to lose reputation – even a shred of reputation."

I think the culture that was built by Warren Buffett and Charlie Munger is the main competitive advantage at Berkshire. The decision to sell a private business to Berkshire is often not about maximising the price achieved but more about protecting a legacy or retaining operation independence. A fifty-year track record of deal making is a very strong competitive advantage.

Berkshire Beyond Buffett

But what will happen after Buffett is no longer around? This is a very important question. Firstly, a succession plan is prepared, in place, and known by the Board. However, it has never been shared with shareholders. I trust the Board when they say that they have adequately planned for this eventuality. Interestingly, during this year's shareholder meeting, Buffett alluded to the possibility that he might be succeeded during his lifetime. This is not something I previously considered likely.

The underlying businesses will continue as before. Buffett is not involved in the day-to-day operations of the businesses. He is, however, intricately involved in the capital allocation and investment decisions. His two investment lieutenants will likely become even more involved in the future.

In terms of future deal making, it is likely that some of the juicy transactions might be less frequent. Berkshire has completed many transactions where the reputation of Berkshire and Buffett added so much value that the agreed price was lower than otherwise available. I am not sure if any successor will have the ability to negotiate similarly attractive deals, but it is possible that a successor might have more energy to look for these deals.

The leniency afforded to Berkshire by regulators might also be linked to Buffett. It is possible that his successor might have more regulatory and disclosure requirements. But this should not hurt the business substantially.

One remaining element is the share price. Were the share price to fall significantly, it would afford the opportunity to buy more shares in the company. Berkshire itself might be able to repurchase shares in the market. Alternatively, Buffett suggested that the share price might increase based on a perception that the business might be broken up and sold in parts. I think this outcome is unlikely. I don't think it is useful to try to predict how the share price will move, but I'll be ready to act if the share price warrants it.

Conclusion

It remains my 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 would also appreciate any feedback on the letter – is there any additional points that you'd like me to cover in these letters?

Your partner in long-term value.

Henno

Disclaimer

This document is intended for the clients of Capensis Capital (Pty) Ltd. All data provided by Capensis, unless otherwise stated, as at 30 June 2017.

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

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