January 2021

Dear Investor

2020 ANNUAL LETTER

This is our fourth annual letter. We realise you could invest with numerous asset managers who have written more than forty annual letters, so we thank you for entrusting your savings to Capensis Capital. Managing your money is our privilege and our passion.

This letter covers performance since April 2017, when Capensis started managing individual accounts. This is a short period in markets but, as explained in our introductory letter, our business is on a multi-decade journey with a relentless commitment to compound our clients' money in excess of US inflation plus 6% per annum.

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%
2020	+23.5%	+7.4%	23%
Total	**+45.0%**	**+32.5%**	
Total annualised	**+10.4% pa**	**+7.8% 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 2020. This is a pleasing result considering the wild swings the markets experienced during the year.

The largest contributors to performance were your semiconductor businesses (Lam Research, Micron and TSMC), MEI Pharma and First Republic Bank. The main detractors were Capital One and Brookfield.

1. ***Semiconductors: Lam Research (LRCX), Micron (MU) and Taiwan Semiconductor Manufacturing (TSMC)***

We have written in previous letters about the investment case for semiconductors. 2020 turned out to be the year in which the investment thesis gained wider enthusiasm in the market, and all three companies enjoyed meaningful increases in their share prices.

These companies benefit from being members of oligopolies in different parts of an industry with strong tailwinds. Their management teams are, along with their competitors, acting rationally in terms of adding new manufacturing capacity. This is largely a function of fewer players across the value chain over time following industry consolidation, and competitors failing to keep up with the pace of innovation. We continue to believe that the future of this industry will be less cyclical than its past, rendering it more attractive than reflected by current share prices. In short, our investment thesis for the industry remains intact.

LRCX has managed to grow its revenue and earnings throughout 2020 and is expected to generate strong growth in the next few years. The growth in equipment spending bodes well for 'semicap' businesses like LRCX.

The memory semiconductors cycle seems to have bottomed and your exposure in this segment of the industry, MU, could experience significant profit growth in the near term as both prices recover and volumes grow.

TSMC remains the most advanced semiconductor manufacturer in the world and may become the contract manufacturer for Intel's next generation of chips. This points to further consolidation, with only TSMC and Samsung being able to produce at the leading edge of technological evolution.

Your exposure to semiconductors is currently the largest single industry exposure in the portfolio. We continue to find other attractive investment opportunities in this arena, some of which may be introduced to your portfolio.

2. *MEI Pharma (MEIP)*

2021 will be an important year for MEIP. We expect data releases in all major areas of the business and remain excited about the prospect for this company.

Zandelisib (formerly known as ME-401) is expected to complete enrolment for its pivotal phase 2 TIDAL study during the first quarter of this year. Top-line clinical data is expected by the fourth quarter. We also expect updates from an ongoing combination study (zandelisib plus zanubrutinib) during the middle of the year. Following the licensing deal with Kyowa Kirin (KKC) that we discussed in our 2020 Q2 letter, MEIP confirmed that they are proceeding with additional clinical trials, to be run in parallel with TIDAL. This is a positive indication of the confidence both management and KKC have in the wide application of zandelisib in different forms of blood cancer.

Voruciclib should see results from an early-stage combination study (voruciclib plus venetoclax) and ME-344 should see a Phase 2 study start in this year.

3. *First Republic Bank (FRC)*

FRC managed impressive growth with very low bad debts in a year in which many US banks struggled due to the economic environment. Rather than discussing this any further, we'd point to the following table from the 2020 results announcement, as it speaks volumes. This bank has had 35 years of profitable growth and is not slowing down.

Full Year Highlights

Financial Results

- Revenues were $3.9 billion, up 17.2%.
- Net interest income was $3.3 billion, up 18.0%.
- Net income was $1.1 billion, up 14.4%.
- Diluted earnings per share of $5.81, up 11.7%.
- Loan originations totaled $50.7 billion (excluding $2.0 billion of originations under the Small Business Administration's Paycheck Protection Program ("PPP")).
- Tangible book value per share was $57.30, up 14.1%.
- Efficiency ratio was 61.9%, compared to 64.2% last year.

Continued Capital and Credit Strength

- Tier 1 leverage ratio was 8.14%.
- Nonperforming assets remained at a low 13 basis points of total assets.
- Net charge-offs were only $2.4 million, or less than 1 basis point of average loans.

Continued Franchise Development

- Loans totaled $110.7 billion, up 21.9% (excluding PPP and for sale loans).
- Deposits were $114.9 billion, up 27.5%.
- Wealth management assets were $194.5 billion, up 28.7%.
- Wealth management revenues were $526.5 million, up 11.9%.

Source: FRC 2020 results announcement

4. Capital One (COF)

We sold out of COF at a loss in March. As discussed in our 2020 Q1 letter, we preferred to allocate capital to Mastercard and FRC, as there was too much uncertainty around what the future held for COF. The stimulus package announced by the Federal Reserve Bank soon after our sale succeeded in supporting the economy to such an extent that our worries about COF never materialised. Fortunately, both FRC and Mastercard benefitted similarly from the stimulus and increased in value from March to December.

5. Brookfield Asset Management (BAM)

We sold your remaining BAM during November.

BAM was one of the first companies in your portfolio and contributed positively to our overall investment performance since inception. Our decision to exit BAM was due to the changing reality for commercial properties – and especially, what this means for debt held against such assets, a strategy BAM uses extensively. Some of the recent actions by management also led us to question whether they are allocating capital to the best opportunities, or to support past transactions.

Portfolio updates

2020 was an active year in terms of portfolio actions. We added ten new businesses in the year and exited seven. The new additions to the portfolio were AIA, British American Tobacco, CTT-Correios De Portugal, Disney, Inditex, Mastercard, Micron, Microsoft, TSMC and Twitter. The exits were Brookfield, Capital One, Disney, Genworth, and L Brands, as well as the corporate takeovers of Hastings and RIB Software. Most of these actions were discussed in previous letters. We discuss the past quarter's changes below:

1. Disney (DIS)

We purchased DIS during March and sold it during December when the share price increased beyond our valuation of the business. The investment case played out much quicker than we anticipated.

2. Hastings Group (HSTG)

HSTG received a takeover offer in August from Finnish insurer Sampo, together with HSTG's largest shareholder, Rand Merchant Investments (RMI). As you know, RMI is also a shareholder of Granate Asset Management, the company that owns Capensis Capital.

By the end of November, the deal was consummated, and your shares were purchased at a price of 250p. This takeover was a positive short-term development, but we admit that we were disappointed to see your investment go at this point in the cycle. There were some positive developments for the industry and the share price still reflected the depressed Brexit environment.

The investment in HSTG generated modest returns and we redeployed the proceeds into BAT and CTT.

3. British American Tobacco (BAT)

The first addition to your portfolio is BAT. BAT is the most globally diverse of the large tobacco companies. Just more than a third of its revenue is earned in the USA, with the balance earned across the world (outside of China). The most significant of these geographies are Japan (6%), Russia (5%) and Canada (5%).

Apart from cigarettes (or combustible tobacco), BAT also sells an increasing number of next-generation or 'reduced risk' products, including vapour, heating tobacco and oral nicotine products. These non-combustibles have grown to generate 10% of revenue.

The global (excluding China) demand for cigarettes has declined over the past decade. Volumes sold by BAT follows a similar reduction. So why would we buy into a declining industry?

BAT operates in a highly protected industry. With legislated marketing limitations, it is very difficult to start a new tobacco company or grow a new brand. New entrants cannot compete on price, as the price of cigarettes largely consists of taxes and duties. It is thus nearly impossible to generate any economies of scale to compete with this very well-established oligopoly.

Additionally, tobacco companies have succeeded in increasing their prices faster than volumes have declined. This allows the companies to continue growing revenues while they slowly reduce their operations to the benefit of profits.

Tobacco companies, however, have fallen out of favour with many capital allocators. This has resulted in selling pressure, which pushed share prices down to levels that imply a future that we regard as overly pessimistic.

How do we expect your investment to deliver growth? We expect that the combustible tobacco business in BAT will be able to generate significant amounts of free cash flow for many years to come. Our investment thesis is that the dividends alone should deliver more value than the current share price.

In addition to the dividend, BAT continues to invest in further research and development into next-generation products. Any success in these products would lead to additional shareholder value. Lastly, if the company succeeds in transitioning from combustibles to reduced-risk products, it could enjoy a rerating as investors develop conviction in the sustainability of the business and eased concerns around its societal impact.

4. CTT-Correios De Portugal (CTT)

Another new addition is CTT. CTT was founded in 1520, making it the oldest company still in operation in Portugal. It listed in 2013 and was fully privatised in 2014 as part of the requirements of the bail-out Portugal received from the European Union.

CTT operates the postal service of Portugal. The current concession agreement between CTT and the regulator does not allow for sufficient returns on capital and was due to expire at the end of 2020. The national lock-down caused delays in the negotiation of a new agreement that would be more acceptable to CTT. CTT is the only operator that could realistically offer postal services in Portugal and we are confident that it will ultimately be able to negotiate a contract on better commercial terms. This could result in material improvements to the profitability of the core postal business.

In addition to the declining business of regular post, CTT has been growing new lines of business, including parcels and an ecommerce platform. Ecommerce penetration in Portugal has lagged the rest of Europe, meaning there is a long runway for growth. CTT's existing delivery footprint across Portugal makes them an obvious winner as the backbone of ecommerce delivery. There is also significant potential for these lines of business across the whole of Iberia.

Lastly, CTT has also expanded into financial services and banking. The retail bank is showing promise, having opened around half of all new bank accounts nationally since it opened in 2016. It maintains exceptionally high customer satisfaction and has recently started to break even.

CTT has an impressive and motivated management team with numerous growth vectors not reflected in the current valuation.

The business of Capensis Capital

Capensis Capital is fully integrated into the research process of Granate Asset Management. During the past quarter, we welcomed two colleagues as Representatives of Capensis.

Catherine Blersch joined Granate at the beginning of 2020 as an analyst, and performed in-depth research on many of the new businesses in your portfolio. Catherine is an engineer by training, holds an MBA from UCT and is a voracious reader as well as an endurance athlete in her spare time.

Alex Dearman is Head of Clients at Granate. Alex has extensive experience in representing asset managers, having represented large firms in both London and South Africa. Between university and a career in finance, Alex was a game ranger in the Lowveld. He knows where to look for leopards, which is pretty much what asset management is all about.

Feel free to also reach out to Catherine or Alex if you have any comments or questions about your investment. Catherine and Alex can be contacted at catherine.blersch@granate.co.za and alex.dearman@granate.co.za.

In memoriam: Jean Marx

The pandemic caused significant grief globally and at Capensis we lost one of our biggest supporters. Jean Marx was a partner at SA Stockbrokers, the business that acts as our local agent to Interactive Brokers. Jean was the person who introduced us to the potential of the Interactive Brokers platform and took us on as a client with nothing to show but hopes and dreams. Always jovial, always ready to help, we knew that we had Jean in our corner looking out for us and enabling our business. Jean played an enormous role in the inception of Capensis Capital and he will be sorely missed. Our thoughts go out to his family and colleagues at SA Stockbrokers.

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 2020.

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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