April 2020

Dear Investor,

FIRST QUARTER OF 2020

Although our primary communication is an annual letter, we share changes to your portfolio and developments at Capensis Capital on a quarterly basis.

**Covid-19**

These are unusual times and we do not have the answers many seek. We don't know much about virology. We don't know how long this will last, and we won't try to guess. It is also impossible to predict how markets will move. We do know that this is going to impact all of us, and it's going to be a challenging period for everyone.

Many people have lost their jobs, many entrepreneurs are battling for survival and in South Africa, many learners have lost their one meal a day. We remind ourselves of this and have launched internal campaigns to assist in our immediate community. We have found that you don't need to look very far to find desperate need.

What to make of the markets? In the good times, markets reward indiscriminately. In the bad times, they punish indiscriminately. We are buying where the punishment is significantly misplaced. This is how, over time, you build a portfolio of "A Team" businesses – and then you keep them.

Now is the time for calm minds and sensible actions. This does not mean pretending that we understand the ramifications of Covid-19. It does not mean buying the shares that have fallen the most. In fact, we're doing the opposite. We are building a "I can't predict" portfolio. We are buying the businesses that are very likely to be around (and prosper) after Covid-19: companies with strong balance sheets that can survive for a protracted period with little or no revenue, and companies that have proven their resilience pre Covid-19 amid recessionary conditions. Conversely, we have sold some businesses where circumstances have deteriorated to such an extent that we no longer feel justified in holding them. We also have a position in cash which provides more options for future opportunities.

There might not be much to celebrate now, but in months from today we will look back and wish we had worried less about falling prices and more about the people around us. Look after yourself and your loved ones. And, while we bunker down, please don't forget your communities.

**Operational update**

Capensis Capital and the whole of Granate Asset Management is fully operational, and we are working remotely.

**Investment Performance**

This letter is designed to be read in conjunction with your quarterly investment statement, which contains all the financial information. As always, feel free to contact us if you would like to discuss your portfolio.

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**Portfolio Updates**

We were unusually active during the past quarter. We sold out of RIB Software, L Brands, Genworth Financial and Capital One. We also further reduced your holding of Brookfield Asset Management.

The cash we realised was used to increase your investments in Exor, First Republic Bank, Howden Joinery and MEI Pharma. We also purchased into new businesses including Microsoft, Mastercard and Inditex.

- **RIB Software (RIB)**

In mid-February, RIB announced that Schneider Electric made an offer to purchase a controlling stake in the business at a price of EUR29.00 per share. This price was 41% above the price at which RIB was trading the day before. The transaction was to be conducted as a tender offer, meaning that shareholders could decide whether to tender their shares or retain them. Management agreed to sell half of their shares as part of the offer and the company agreed to tender all treasury shares.

The timing of the tender offer was very fortunate. Not only did you receive a significant gain on your RIB investment, but we were able to sell the shares in the market and increase your cash balance by around seven percentage points. This meant the we had additional resilience going into the market declines in March. We redeployed the proceeds into the purchases discussed later in the letter.

- **L Brands (LB)**

Our investment in L Brands was a mistake and it cost us dearly. Our initial thesis revolved around the turnaround potential in the business following the self-inflicted damage done to the Victoria's Secret brand. However, the turnaround never materialised, and we were slow to act on the changing social and retail landscape in which LB operates. We sold LB following the disappointing Christmas 2019 season.

It is worth noting that Bath & Body Works, the bath and beauty retailer within LB performed much better than expected. However, not even its strong performance was able to balance the deterioration at Pink and Victoria's Secret.

We are disappointed with the outcome of this investment. We received a painful reminder that retail turnarounds can take longer to turn around than you expect.

- **Genworth Financial (GNW)**

Genworth was a special situation we have covered in the past.

While material upside remains to the announced deal price, the likelihood of successful conclusion deteriorated when previous approval of the deal lapsed. This meant a new round of regulatory applications that would delay the deal again and, combined with the on-going US-China trade war and other deals being cancelled due to the pandemic, changed the odds of the deal.

We sold your small position for a small profit.

- **Capital One (COF)**

The world changed for many of the clients of Capital One as they are in the eye of the virus storm and increasing numbers of people file for unemployment. COF has historically been very successful in extending loans to people with less-than-pristine credit records, but we feel that the risks under a protracted economic disruption outweigh the benefits. There is little doubt that the current earnings power of COF has reduced.

We have sold COF at a loss and redeployed into financial companies with stronger long-term positions. These include First Republic Bank and Mastercard which are discussed below.

- **Brookfield Asset Management (BAM)**

We continue the process of selling Brookfield and redeploying the proceeds. BAM runs a levered strategy of investing in real estate, infrastructure and private equity. While we have great respect for the business built by the team at BAM, we grew increasingly uncomfortable with the high levels of gearing against office and retail assets globally.

There is a risk that the current shelter-in-place orders globally force the transformation of brick and mortar retail, as well as office occupation, faster than BAM's portfolio will have the ability to transform itself. People are forced to adjust to a new reality and are in many cases doing so extremely successfully. Videoconferencing and collaboration apps are two examples making office life less relevant. So too is an increasing reliance on delivery services offered by online retailers. The world is changing at a remarkable pace.

This negative view is one of several potential futures. Another sees BAM able to deploy large amounts of its committed capital into value enhancing acquisitions across its areas of focus. Your lower exposure to BAM reflects some of this dynamic.

- **Exor**

Exor entered into an agreement this quarter to sell Partner Re to Covéa of France. The indicated price was $9 billion. Exor bought Partner Re in 2016 for $6.7 billion and have received $661 million from the company. To be honest, we are sad to see the business sold, but we have a very high level of confidence in the capital allocation skills of the management team at Exor.

The Partner Re deal has not closed. However, were it to proceed, the rump of Exor sells at a 50% discount to their quoted market values.

There is a lot of optionality in Exor currently. As previously discussed, FCA is in the process of merging with Peugeot. Successful conclusion of this might deliver as much as EUR1.6 billion as a special dividend is paid as part of the deal. Furthermore, CNHI is in the process of separating its agricultural business from the trucks business. Within the Exor group, previous actions to created focused groups have generated significant value.

This all means that Exor might receive as much as $13 billion in cash within two years. This compares to a current market capitalisation of a similar amount all the while retaining its investments in Ferrari, FCA, CNHI and others.

We increased your investment in Exor during the quarter.

- **First Republic Bank (FRC)**

FRC share price declined during the sell-off in March. We see little deterioration of the business and used the opportunity to allocate more of your investment to the bank. FRC continues to bank high net worth individuals as well as their businesses and charities. It is an understandable bank that does not participate in any of the exotic areas of banking that often leads to problems in difficult times.

- **Howden Joinery (HWDN)**

Similar to FRC, Howden's share price fell in March and we increased your investment. HWDN has a strong balance sheet and generates high levels of cash flow. The depots of HWDN are all closed during the lock-down, but we expect kitchen refurbishments to recover quickly.

HWDN will retain its cost competitiveness and will be even more important in the lives of its customers (the small builders who depend on it for inventory and working capital) once the world normalises. Being stuck at home (or working more from home) might very well lead to a further appreciation of the benefits of modern kitchens leading to demand for upgrades.

- **MEI Pharma (MEIP)**

Since our first investment in MEI Pharma, we have had the wonderful experience that every piece of news from the company was positive. Clinical trials are progressing, and the science is indicating improved efficacy and safety compared to other approved substances.

However, the share price has not reflected much of this good news and during March, it declined significantly. As discussed with other holdings, we used this opportunity to increase MEIP to a substantial holding in your portfolio.

MEIP is currently the business with the most potential upside in the portfolio. Some people might be sceptical when we say that MEIP could be trading at 10c in the dollar. The fact is, in our blue-sky scenarios, the upside is materially more than 10 times.

There are several data points that we expect to be released in the coming quarter. We look forward to reporting these to you.

- **Microsoft (MSFT)**

The first new company in your portfolio is Microsoft. We don't think the business needs any introduction as it is used by billions of people on a daily basis. It is also a popular holding across many portfolios – not where we would normally focus our research.

We had the opportunity to purchase shares in MSFT during March at prices that made sense to us. We think that MSFT has some of the strongest businesses around and will benefit for many years from the actions of the current management team.

We know that our own business would grind to a halt without MSFT and we know that we are not alone. In fact, most businesses are seeing increasing use of the products MSFT has packaged together within Office 365. Teams is one such an example but by no means the only one.

MSFT comes with the benefit of more than $50bn of net cash on its balance sheet, high profit margins and organic growth.

- **Mastercard (MA)**

Mastercard is another new holding that needs little introduction. MA is one of the major players enabling "a world beyond cash" and facilitating financial transactions globally. It earns fees based on the volume and value of transactions it facilitates and participates in.

It is a high-quality business that is seeing some near-term difficulty due to the global response to the pandemic. Cross-border transactions, travel and accommodation are all major contributors to MA's business. In fact, with so much of global economic activity at a slow-down, MA's ability to charge a toll on financial transactions is temporarily impaired. In our assessment, this is not a permanent situation and the expected growth in non-cash transactions are due to continue.

The recent market declines provided the opportunity to invest in MA.

- **Inditex (ITX)**

The last new holding in this letter is Inditex. ITX is one of the largest fashion groups in the world and is best known for its flagship brand, Zara. This is another remarkable business that offered a buying opportunity in March. The company is family controlled, has more than EUR 8 billion of cash and short-term investments and hardly any debt on the balance sheet. This is in stark contrast to many other retailers with stretched balance sheets. We think ITX has staying power and will be operating from a position of strength when the markets reopen.

- ***Cash***

Cash remains the largest single holding in the portfolio. As previously explained, cash is our default position and 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 some 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.

**Conclusion**

It continues to be a pleasure and a privilege to manage your investment. Please do not hesitate to contact us if you have any questions regarding your portfolio.

Your partners in long-term value,

Paul and Henno

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**Disclaimer**

This document is intended for the clients of Capensis Capital (Pty) Ltd. All data provided by Capensis, unless otherwise stated, is current as at 31 March 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.

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.

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