SALTLIGHT CAPITAL

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17 July 2016

Dear Fellow Partner,

I am pleased to share with you my maiden annual letter to shareholders for the financial year ending 30 June 2016.

SaltLight's operations started seven months ago on 1 December 2015 with the aim of offering shareholders a vehicle to generate long-term shareholder returns earned in the 'right way'.

SaltLight's Performance against the JSE All-Share Index

Year		**Annual Percentage Change**		
	Per-Share Book Value	In Per-Share Book Value of SaltLight (net of fees) (1) [2]	Overall Result from JSE/FTSE ALSI with dividends (2)	Relative Result (1) – (2)
2016 [1]	106.40 [2]	6.40%	2.53%	+3.87%

1. SaltLight started operating from 1 December 2015. Therefore, all returns are shown from 1 December 2015 for seven months of operations.
2. Provisional return - the 2016 Financial year results are still subject to final audit sign off.

Our results were satisfactory considering that we only had one oar in the water for most of the year. I place importance on discipline to wait for the 'best' opportunities and therefore our portfolio had 50% of our assets in cash for most of this financial year. To date, we retain 22% of the portfolio in cash and I will deploy it when attractive opportunities arise.

Many investors are fearful about the state of South Africa, the world economy and what investment performance will be like over the next few years. I hear friends, family and colleagues consistently weighing up whether to shift their investments offshore to developed markets. While I cannot give anyone an answer, it is my view that it helps to contextualise history, look out for 'crowded' situations and then diligently consider the investment strategy one applies. I discuss in this letter some thoughts around the general environment, our investment strategy and some examples of how this is applied. If you wish to jump over my thoughts and just read more about our performance, see the section "Business Matters" below.

Topics covered in this letter are:

- History has rewarded South African investors who stayed in turbulent times
- I'm a South African, get my money out of here!
- Our method of operation sows in times of distress and reaps in times of plenty

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1. The General Environment

In talking about the general environment, I make no attempt to forecast the market – I only wish to provide context to SaltLight's investment decisions.

Since starting SaltLight, the South African economy has gone through arguably one of the worst macro-economic crises since our democratisation in 1994. Two weeks after we started operations, the South African Finance Minister, Nhlanhla Nene, was inexplicably replaced by President Jacob Zuma. Naturally, within a few days, the ZAR had depreciated markedly, financial services stock sold off aggressively and the public mood turned diabolically negative. In addition, there had been global risk events surrounding China and the impact of a British referendum to exit the EU. All have caused fear in many market participants.

Over the years I have observed that market behaviour can be distilled into a simple formulaic heuristic:

Fear of future + an element of truth to fear = Uncertainty

Uncertainty + observation of price action = re-enforcing price action

Result: over-optimism or over-pessimism = opportunities.

My efforts at SaltLight are focused on finding undervalued securities in the market <u>whenever they may occur</u>. My research begins from the bottom up. I usually find these undervalued opportunities in times of crisis and in the days of 'Nene-gate' SaltLight was an aggressive buyer of banking and insurance stocks, that so far, have turned out relatively well for the portfolio.

I am cautious as always and ever-mindful that there are many macro-economic risks that could cause a market decline from current levels. To a great extent, the JSE All-Share index does not give a true picture of the local market as many of the largest blue-chips are well 'internationalised'. Furthermore, one only needs to see the Rand's depreciation as the true barometer of 'SA Inc'. If the JSE All-share were to be converted to a US$ base, SA would be firmly in a bear market for the last two years.

In future, it is realistic that our portfolio would most likely trend with the movement of the general market and suffer a *quotation loss* should the overall market decline. This point of a 'quotation loss', is important and worth reminding partners that the closing price of a share on the stock market is merely a quotation of what Mr. Market is willing to buy your shares back from you on a certain day. Often, this price does not reflect the underlying intrinsic value of a particular business. For the sake of accounting and book value, I mark our investment values to these quotations every month. However, by the very nature of still holding these investments, I believe they trade at a discount to intrinsic value and there is still opportunity to be had.

1.1. History has rewarded South African Investors over time

The JSE has shown an uncanny ability to get back on its feet many times over. However, there were lengthy periods of loss that, I imagine, investors could not see an end to.

Period	Date	JSE All-Share Index	Return During Period
End of the bull market	May 2008	33,233	
End of the bear market	9 March 2009	18,121	-45%
SaltLight started	1 December 2016	51,536	+181%

When SaltLight opened its doors, the South African stock market since early 2009, and for the most part, global stock markets, had an unbelievable run.

The JSE All-share index closed at 18,121 on 9 March 2009 (which was roughly the bottom of the 'Great Recession' market declines) and on the day we made our first investment, it closed at 51,536 – a rise of 181% over six years.

Let's go a bit further back in history: at the height of the bull market in 2008, the JSE closed at 33,233 in May 2008. Within a year, it had dropped from 33,233 to 18,121 (a drop of 45%) and - then went on to advance to 51,536 (+181% over 6 years later).

The JSE during the 'Great Recession'

In 2008, I was a young analyst working in a local investment bank when all these events unfolded. To some extent, I have been fortunate to see that *things can always get worse than you think*. However, the converse is also true - *things always get better than you think*. If one had stayed out of the market after the 45% sell off in 2008 and sold at the bottom of 2009, one would have missed reclaiming the quotation loss back over the next three years (between 2009-2012) and suffered the additional pain of missing a considerable rise in the market since then.

We always need to be mindful that there will be times of despair and times of euphoria. We just don't know when they will occur. Therefore, I am rigidly focussed on applying the principles of Value Investing and navigating the opportunities with the long-term perspective in mind - however we should always brace ourselves for negative returns in the short-term.

1.2. I'm a South African, get my money out of here!

When finding opportunities, a manager should always be mindful of 'crowded' situations. Contrarianism is, however, lonely. Market participants tend to follow similar 'thematic' investment decisions which can lead to sizeable capital sitting in the same exposure. Ultimately, when expectations are not met, the herd often quickly leaves the room.

One theme that has been percolating and consistently viewed as 'gospel' is that Rand depreciation will last forever (*fear*). The re-enforced rationale is the political environment and cash-strapped financial state of the South African citizenry (*element of truth*). Economic participants across the whole spectrum of the South African economy have seen the movement of the Rand (*observation of price action*) and have been shifting capital one way – that is offshore.

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One prominent medical and insurance company summed up the mood well and wrote in a USD offshore product prospectus: "*wouldn't you want to protect yourself and your family against this uncertainty?*".

Anecdotally, I have been observing many across society acting on this prevailing narrative at whatever the cost and potential risks:

- Retail investors continue to invest in offshore funds at R17:$1 into fixed income markets with negative interest rates and stock markets at all-time highs;
- Companies, large and small, have been 'externalising' their capital by buying offshore businesses using a historically 'cheap' Rands and topping up the purchase price with foreign debt at ultra-low interest rates;
- It has become a small sport amongst local property companies to purchase the *most* exotic Eastern European shopping mall in the name of obtaining a Rand-hedge exposure;
- The abovementioned medical and insurance company is offering a widely-advertised life insurance product denominated in US Dollars. The benefits are linked to US inflation notwithstanding that most of the developed world is trying to avoid deflation;
- Lastly, the very newspaper built on rational economic thought - The Economist – has made the decision that it is no longer quoting subscriptions in ZAR and is only priced in US Dollars!

Against this backdrop, I have also had many questions from investors as to why SaltLight does not take our capital and invest it offshore.

Ultimately, I favour investing in any jurisdiction however I retort that SaltLight's method of operation is to search where *value* is located and not where is popular. South Africa has digested many events in the past and has soared to new levels each time to those who were patient and had a long-term view. At this present time, I am not disregarding the notion, however I are always mindful to allocate capital for the purpose of opportunity rather than fear.

South Africa has survived the Nationalists coming into power in 1948 where investors had to endure a 55% decline in real terms over 15 years. It survived becoming a Republic, Sharpeville, sanctions and the Rubicon speech. In the 1969 crash, investors lost 64% of wealth in two years – and survived. Whatever may happen, history has shown that SA can do it again.

I can hear a few readers already saying "*but, this time is different*". Take heart that SA has some fundamentally advantageous trends that are reason for optimism. South Africa has a growing population, a rise in property ownership and a growing middle class that is yearning for advancement. These new consumers will need to buy products local companies produce; they will need infrastructure, services, bank accounts, energy, homes, security, insurance and even cars.

Often picking a good investment requires investors to identify 'big ideas'. One particular 'big idea' is population demographics. The reason why one has to consider this over the next few decades is that developed-market returns on investments will almost certainly be influenced by this 'idea'.

Many developed nations suffer from what the experts call sub-replacement demographic trends – de-population. I was startled to find out that Europe reached their peak population in 2000 and by 2050 its population is expected to have dropped by a fifth[1]. In cases where countries have tried to rectify the situation through migration, the unintended result can be seen in recent events this year: Brexit, the rise of Donald Trump and the potential disintegration of the EU Project. Yet, few politicians have vocalised the effects of de-population to their constituents. Imagine a world where there are less cars needed, less real estate needed and less infrastructure needed because there are less people tomorrow than there are today!

South African financial institutions are world-class, our markets offer excellent disclosure, reporting and audit compliance. Despite deep political uncertainty, businesses are building intrinsic value notwithstanding the environment.

At SaltLight, I try retain sober judgment about the current environment. My investment horizon is longer than most and is focused on decades rather than years. As a shareholder, I would rather SaltLight sustain short-term underperformance in order to be long-term greedy. Many market participants are missing the fact that local companies with 'not enough' offshore exposure who are fully exposed to 'SA-inc' are on offer at <u>very</u> attractive prices.

In order to be successful, we only need to find twenty great investments over the next ten years amongst a sea of uncertainty to realise wonderful long-term returns.

1.3. SaltLight's Method of Operation Sows in Times of Trouble and Reaps in Times of Plenty

It is worth reminding partners, that our method of operation is value-based, conservative, long-term focused and averse to companies who have management with poor judgement or capital allocation skills. Our investees are usually palpably boring businesses that are in temporary disfavour.

The Value Investing principles were first documented by Benjamin Graham and David Dodd in 1934[2] and were formulated during the Great Depression in a time far worse than many living today have ever experienced.

Graham and Dodd outlined many wonderful principles, however two notable tenets were (1) having a margin of safety and (2) thinking long-term by imagining owning a piece of a business and not an intangible piece of paper.

Margin of safety

The margin of safety is the difference between the *price you pay* for a business and *the value you get* for it (intrinsic value). To put it in simple terms, to pay R50 for something that is worth R100. The 'discount' is to compensate the investor for any errors in judging value but also for the unpredictability of short-term declines in value. What I look for are businesses that have staying power over decades, where management is allocating capital that

[1] http://pages.eiu.com/rs/783-XMC-194/images/Long-termMacroeconomicForecasts_KeyTrends.pdf
[2] Security Analysis by Graham and Dodd, 1934 ed.

generates returns with each new Rand invested and most of all, being offered by the market at a sufficiently discounted price.

Assessing value is rarely easy. Realising value is an exercise of patience, discipline and steadfastness in times of uncertainty. We are only able to realise that discount to intrinsic value over the long term and therefore our method of operation is to assess value as a private business owner would.

Thinking like a business owner

When evaluating a prospective business, I assume the stock market does not exist. I am concerned about the earnings of a company over a lifetime and I'm willing to hold our investment forever. Thinking about 'forever' holding periods causes one to think about the industry, the competitive environment, the barriers to entry, management and their allocation of capital. In the event of a short-term quotation losses and the investment thesis still holds, it is a potential opportunity to allocate additional capital at an even better price.

It is helpful to remember that in a difficult economic environment, all companies in the same industry are subject to the same environment. The strongest player should come out stronger if the competitive forces are favourable for that business within their particular industry.

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2. Our Portfolio

Our portfolio ended the year with ten investments. This is a noticeably concentrated portfolio compared to some unit trusts where there could be 30-40 investments. Having 30-40 investments, by nature of mathematics, is quite likely to result in average performance.

Our method is always to apply capital to the best ideas and allows me, more importantly, to focus. It is better to monitor a few companies deeply rather than have a cursory knowledge about many. As mentioned above, at year end our portfolio has high levels of cash waiting for opportunities. The high cash levels are partly due to new shareholder subscriptions and partly because I am waiting for value to appear.

I have modelled SaltLight's portfolio construction on Warren Buffett's original partnership model. The intention is to allocate 80% of capital to what Buffett called 'generals'. These 'generals' are a portfolio of undervalued assets where it is uncertain when the gap in value will narrow. The assets tend to lack glamour or there is an uncertain timeframe around events that could unlock the identified value. They are just trading at a comfortable margin of safety with a low probability of permanent capital loss. Unfortunately, 'cheap' does not mean they will not go down in sympathy with the market. But over the long-term, I expect that they will outperform the market. My intention is to have 5-6 fairly large positions (of 5%-10% of assets) and 5-10 smaller ones.

The remaining 20% is allocated to 'special situations' where the results depend on corporate action (spinoffs, mergers, buy-outs) and, generally, performance is not correlated with the market. Holding periods shall vary depending on the situation however usually there is some timeframe for 'action' to occur. There will be degrees of uncertainty due to deal delays or other events however we aim to act when there is a small margin of error. These

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investments are situationally dependent however 5-10 could be envisaged. To date, the portfolio has two of these investments.

I'd like to introduce you to two of your investments. In the interest of candour notwithstanding my statement above that I would like to disclose as much as possible. In cases where I am still actively purchasing investments, I shall defer giving a name and specific detail about a particular investment. Ideas are SaltLight's only intellectual capital and I'd prefer that I do not jeopardise shareholder returns for the sake of public information. I trust that you will understand and I look forward to discussing these once I have completed our transaction activity.

2.1. Trellidor Holdings

Trellidor listed on the JSE in October 2015. *As an aside, I have a general rule of not investing in IPOs, knowing that they are usually priced for perfection. The only beneficiaries usually are the sellers and their investment bankers (a tribe, I must admit, that I once belonged to).* Unsurprisingly, the stock quickly sold off 30% from its listed price during the year. The underlying business, however, did not escape my 'value' radar.

It was in the difficult markets that I was able to buy a wonderful business at an attractive price. Trellidor is a world-class business that will have customers in South Africa for years to come. One must remember that derivatives of its product have been used for defences since man entered the iron age. In tough economic times, crime usually rises and so does demand for security products. Trellidor is the market leader with 30% market share and the only one with a national footprint. It has a few key factors that tantalise any value investor's taste buds: 1) great management 2) an agency distribution model 3) requires little capital to grow 4) attractive and growing competitive advantages.

Trellidor sells a custom-manufactured gating product nationwide through a network of franchisees to end-users. The 'franchise' model can be a wonderful business model for investors as shareholders obtain many of the benefits of a large distribution channel without paying for them – capitalism's equivalent of social benefits. In Franchise systems, the business's distribution channel is financed by owner-operators who want to 'live the dream' of working for themselves. The owner-operators will stump up a large portion of initial capital to employ staff, pay rent and offer unpaid 'sweat' equity with full responsibility for the operating risks of the business. It is a model that consistently yields far better performance than employee-led businesses. The franchisor's (Trellidor) job is to build a brand and sell product to their franchisees. Trellidor uses its scale to advertise nationally (building their customer captivity) and makes money on the goods sold to franchisees at 50% gross margins. In this case, the Franchisees operate as agents of Trellidor's manufactured product.

The agency business model offers a cocktail of strong forces that create wonderful returns on invested capital. First, there needs to be a seemingly 'independent' intermediary who buys on behalf of the end-user. Second, there needs to be a product that is complex or difficult for the end-user to determine the perceived cost vs the actual cost. Lastly, add a twist of common-interest incentives between the seller and the intermediary. If the seller sells at a higher price, the price of the product is not of a key concern to the intermediary as they simply charge the end-user more. The intermediary is more concerned about the quality and the ease of installation of the product – rather than the price. This model is often well-hidden, but can be found in insurance, plumbing, financial advisors and your even your local dentist – *does your dentist ever phone around for three quotes to get the best price for your dentures?*

Trellidor does suffer with one immediate challenge. It's producing more cash than it needs for internal operations. We're highly conscious that the CEO's primary role is the allocation of capital. Much of the future returns of a company are determined by this very important role. I was pleased that during the year Trellidor purchased Taylor Blinds at a 5.7x historic PE and at a reasonable premium to book value – an example of good capital allocation. From discussions with management, it is likely to be very complementary to the Trellidor's 'made to fit' home product offering with upside from distribution though their nationwide network of franchisees.

It is these factors: 1) the manufactured custom-fitted products 2) franchise distribution system and 3) well-established national Trellidor brand, that Trellidor has tantalising high returns on invested capital and is very cash-generative. We're excited for what value the business will develop in the future.

2.2. Master Drilling

It is no secret that the resources sector has taken a beating in the last three years. Fundamentally, a commodity producer should over the long-term earn - at most - their cost of capital. Theoretically, this means no growth in 'value' for a shareholder over the long-term. The reason is because of what their primary product says on the can – *it is a commodity*. It is a product that has no brand and no customer captivity. A wedding ring manufactured with Russian platinum is no different to one made from Rustenburg platinum. A commodity's value is created purely based on the vagaries of supply and demand. The lowest cost producer is usually the one who wins in the long-term.

Much of the JSE bourse should therefore create no theoretical economic value and it is our job to find value in unloved corners of the market. Recently, anything in proximity to mining has been quickly dismissed by many in the market.

Yet, we have found a business in the mining sector that *actually* has an economic moat. Pricing power is usually the best defensive position of an economic moat and finding the competitive dynamics that foster pricing power are hard to identify. This business operates in a niche segment of mining services. It has grown earnings power at 12% pa since the top of the resources cycle in 2012 and it has even accelerated incremental returns on capital over that time.

Master Drilling (MDI) is the world's largest raise-bore driller with customers in multiple continents. *What is a raise-bore drill?* It is a very large machine that bores a circular hole for the purposes of ventilation shafts or other vertical shafts to depths of up to 8kms underground. Some astute readers might ask how it is possible that in a world awash with supply of commodities - there is even the possibility of the need for more holes? Notwithstanding the decline in commodity prices, blue-chip miners need to continue with production. They have obligations to pay employees, repay debt taken in boom times and even eek out dividends for equity investors. Many are selling production at prices below cost due to oversupplied markets.

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Over time, deep-level miners in production phase need new shafts. They can either use explosives or sophisticated raise-bores drills. Raise-bore drills are safer and much less labour intensive. The miner has the option to buy one and, in turn, employ a team of operators at a great capital cost. Alternatively, it can enter into a contract with a specialised raise-bore driller. Enter Master Drilling: I believe MDI has (1) pricing power due to specialisation and being a niche product in a small market (2) high-barriers to entry due to technical know-how, economies of scale and customer captivity.

MDI is not beholden to any particular commodity and is able to pack up and ship its rigs to anywhere in the world where there is demand.

Pricing power originates because the ventilation shaft is a small part of the total production cost of a mine site. Therefore, what the miner wants is speed, safety and the job done right the first time – rather than at the lowest cost. MDI also becomes entrenched at each mine site. Often, in a long-term contract, the machine is purpose-built for the particular geology and it is very hard for a competitor to get in once MDI gets its foot in the door.

The raise-bore drilling market is a small market. I liken the situation to a small town that only can support one general store. When a potential competitor is looking to enter the town, they quickly evaluate that two stores can't survive in such a small town and decides not to enter. By virtue of little or no competition, that lone store is able to charge more.

At the current valuation, we have an advantageous entry price for the current earnings power. Competitors have been slowly exiting the markets MDI operates in and in some cases MDI has been acquiring some at fire-sale multiples. Furthermore, there is upside optionality for when the commodity cycle does pick up – however we do not pin our hopes on this over the next few years.

As I said, we own *boring* companies!

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3. Business Matters

Our performance in 2016 was satisfactory considering that I have only deployed capital when opportunities arose during the year. All growth in per-share book value is after taking into account performance fees, taxes, trading costs and a small provision for audit costs.

As you will know, SaltLight's remuneration structure is somewhat different to traditional asset managers where my aim is to align interests between Managing Partners and Investing Partners. In terms of the shareholder's agreement, I am only remunerated if my efforts lead to positive growth in per-share book value, after fees - above the hurdle rate of 9%. I have pro-rated the hurdle rate this year to account for the fact that SaltLight only operated for seven months rather than twelve. Therefore, the hurdle rate was 5.25%[3] for the 2016 financial year.

[3] Calculated as (9% x 7/12 = 5.75%)

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Warren Buffett once described the concept of 'par' for any capital allocator in deciding their worth. In our context, the JSE All-Share return (including dividends) measures 'par' for us. If I am not beating the index over the long-term, I should be investing my capital in other places and so should you. I feel however, that the adequate time to judge performance is, at a minimum, over five years to allow SaltLight's investment strategy to play out.

There are no management fees in SaltLight (these are typically 1%-2% in other funds) and the fees as described above are only based on absolute performance. This year, I am pleased to exceed the hurdle rate and the JSE All-share Index - in return the effective cost of managing your money was 0.26%[4].

I cannot promise results to partners. I can promise that our investments will be chosen on the basis of value. I endeavour to ensure that risk is minimised by buying investments with a comfortable margin of safety.

If, in the future, I do obtain an undesirable result, I would like to remind Partners that I share in all the ups and downs with investors. All of my liquid wealth is invested in SaltLight on exactly the same terms as yours. On top of this, I am not rewarded for results below the required hurdle rate.

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In closing, I have the best job in the world. I consider it an absolute honour to be a steward of shareholder's funds and a custodian of your wealth. In due course, I shall be announcing details for our annual general meeting where we can meet face to face. I will be happy to answer any questions that you may have.

Please take care to note that the above performance figures are provisional and still subject to audit sign-off.

Once our results have been fully audited, I shall be able to provide audited financial statements to shareholders.

Your sincerely,

David Eborall

[4] Calculated as after-tax variable performance fees taken as a percentage of aggregate net asset value (does not include compliance costs, statutory expenses and taxes)