SaltLight Capital
Unit 3 Brookwood, 50 Hyde Close, Hyde Park,
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Telephone: (011) 268-6057
Website: www.saltlight.co.za

Quarterly Update: 1st quarter of the financial year ended 2017

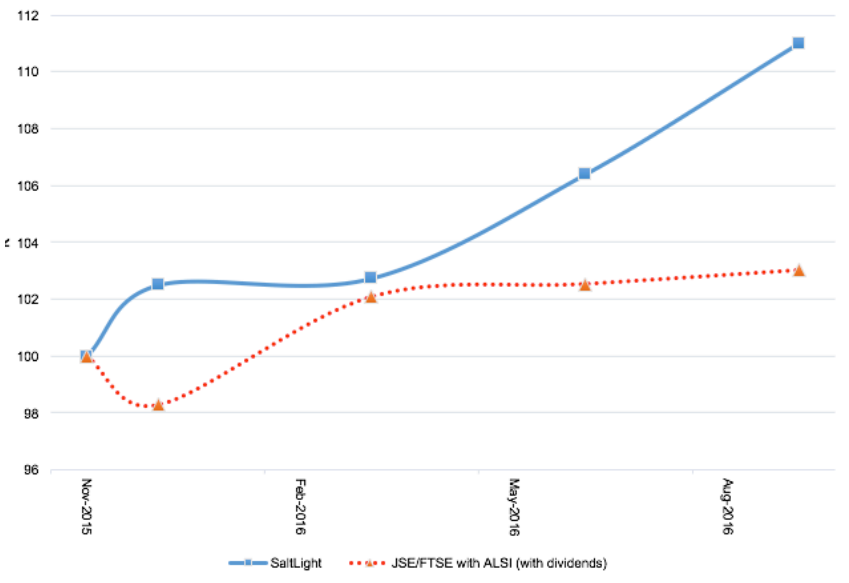
Dear Fellow Shareholders,

SaltLight Capital is an investment holding company that seeks to invest your capital for the long term with the objective of growing net asset value[1] per share on a sustainable basis. Capital is allocated to a concentrated selection of my best ideas in wonderful businesses with durable competitive advantages, competent and trustworthy management who run their businesses with sound long-term principles.

Period		Period Percentage Change		
	Per-Share Net Asset Value[1]	In Per-Share Net Asset Value of SaltLight (net of fees) (1)	Overall Result from JSE/FTSE ALSI with dividends (2)	Relative Result (1) – (2)
2016[1]	106.40	6.40%	2.53%	+3.87%
2017-Q1[2]	111.00	4.33%	0.48%	+3.85%
Cumulative since inception		11.00%	3.02%	+7.98%

1. SaltLight started operating from 1 December 2015. Therefore, all returns are shown from 1 December 2015 for seven months of operations.
2. SaltLight's financial year ends on 30 June therefore the period 2017-Q1 represents 1 July 2016 – 30 September 2016

Value of R100 invested in SaltLight relative to the JSE/FTSE ALSI (with dividends)



[1] Net Asset Value (NAV) represents assets (investments) plus cash less liabilities and is the best measure of net worth (according to accounting rules) to SaltLight shareholders. The NAV is divided by the number of class A shares outstanding (NAV per share) to obtain how much of net worth belongs to each holder of a share. Accounting net worth will differ to intrinsic value.

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Investments

SaltLight is currently invested in nine businesses that are listed on the JSE. When allocating our capital, I view our investment decision as buying a piece of a business and SaltLight becomes a partner to that business. The market is continually quoting prices on a daily basis to purchase or sell any business. The rules of accounting dictate that SaltLight's proportional interest in the business be reflected at these monthly closing market quotations whether or not we have a differing assessment of its value. Therefore, the accounting values should not be seen as the true value of SaltLight's net worth but rather an approximation.

My investment criteria are as follows:

(1) A business that I am able to understand and have a reasonable assessment of long-term staying power;
(2) A quality business with durable competitive advantages that compound at high rates of return on invested capital;
(3) Run by competent and ethical management who operate with all stakeholders in mind;
(4) Available at the right price and therefore trading at a discount to intrinsic value.

During the quarter, many of our investees reported interim or annual results. Considering the current environment, I was genuinely pleased that the managers of our businesses are not putting their heads in the sand and are investing for the future to grow intrinsic value. Some have been using economic weakness to acquire competitors or grow into other geographies at 'fire sale' prices.

A depressed economic environment tests the strength of my original investment thesis as a defining pillar is the ability of the business to grow intrinsic value in tough times. I thought I would report back on two sets of results:

Trellidor

Trellidor reported their first set of results after listing in October 2015. You will remember from my June 2016 letter to shareholders, that I introduced this wonderful company. The reported numbers actually understate the impact of significant events in the business namely (1) the raising of primary capital from JSE shareholders and (2) Trellidor's acquisition of Taylor Blinds that is yet to be reflected in the results (as the transaction was not yet effective by their year-end).

- Revenue increased by 6.7% to R313m and operating margins improved to 24% (2015: 23%) – these incorporate one-off costs from listing and the Taylor Blinds acquisition and therefore are actually much better.
- Headline earnings per share increased by 11%
- Return on invested capital 29%[2]

Many investors would see the revenue growth of 6.7% and label Trellidor as a slow-growth mature business. What is not appreciated is its cash-generation ability due to the high returns on capital that it earning. It simply does not need much to keep the lights on and therefore management is returning roughly 50% of profits to shareholders and using excess capital to buy businesses at low prices. Taylor Blinds was purchased at a 18% yield (without factoring in future growth) and therefore the redeployment of excess capital will yield solid returns in the future.

[2] Return on invested capital is the investee's return on average capital employed comprising of equity, debt and minorities.

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Howden Africa

Howden Africa manufactures, distributes and provides after-market service to mining, power and industrial companies in Southern Africa. Howden's products are enormous fans for use in power stations, mining ventilation and any industry that generates airborne waste. Usually, industrial manufacturing companies are capital-intensive and struggle to generate high returns on capital. The reason is that economic value is generated by converting capital into production. Any new entrant is able to enter into the business if they have adequate capital. Without durable competitive advantages or "economic moats", competition drives down return on capital to cost of capital in the long term – eroding "value creation" for shareholders. *Howden, however, is different*.

When Howden installs its fans, it is able to sell after-market services to its customers for years thereafter. The fans are custom-made, technical and usually if the fan breaks down, it can be very costly to a customer. Therefore, a customer is highly likely to return to Howden rather than a cheaper competitor for parts and servicing. Howden has a captive installation base and is able to maintain pricing power for many years after the product is manufactured. The effect of this is that returns on invested capital are mouth-watering.

Here is a layout of the complexities that Howden is facing:

(1) The pedestrian political environment and general slowdown in industrial production brought the stock down from R50/share to the high teens over a two-year period. I believe that most investors focused on the 'manufacturing' side of Howden's business and rightly anticipated Howden's customers would be reducing their capex to the bare bones. However, its high-margin after-market business has been able to hold up revenue such that it represents 69% of total revenue. The installation base has to continue maintaining their assets and Howden is benefitting;

(2) Howden was historically a high-paying dividend stock and attracted income-hungry investors. In 2015, Management, who are extremely conservative, suspended Howden's dividend.

(3) Despite not paying a dividend, it has been paying management fees to its 55% majority shareholder, Howden Global, who in turn is held by Colfax. Many market participants feel this is a 'quasi-dividend' that minority shareholders are not participating in. However, my view is somewhat different in that its parent companies provide technical know-how, systems and a management culture that Howden Africa, as a stand-alone entity, could not replicate with economies of scale. It is better to think of it as a royalty paid in a franchise business.

Howden's share price when we purchased our first investment was R22/share. It has zero debt and roughly R8/share in cash on the balance sheet. As of today, it is quoted at R32.

My view is that one of these potential scenarios are quite likely to happen:

(1) **Minority buyout:** Eskom is a significant customer of Howden's who is continuously driving transformation. Management has needed to do a BEE deal and therefore has consistently communicated that it is holding excess cash back for a deal. The introduction of new shareholders would bring the parent company's 55% shareholding down below a controlling interest. Therefore, a potential scenario is that shares are bought back from minorities with the excess cash.

(2) **Cash returned to shareholders:** The growing cash pile could result in a generous special dividend being paid;

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Howden reported their interim results during the quarter:

- 1H16 Revenue was 3.7% up at R702m however I'm expecting it to be negative for the full year as management's order-intake data points show orders have slowed;
- Interim headline earnings grew 1.2% YoY
- Average return on invested capital is 25%[3]

While we wait events to unfold, permanent capital loss is limited and we own a business at a favourable entry price with an attractive discount to intrinsic value - whether or not one of the above events do happen.

Final comments

I am extremely cautious at the moment – partially because it feels like the ocean is calm before a big wave is building up. Implied volatility (effectively the ECG read-out of the market) is at a 30-year low and seems to hide potential risks lurking in the water. I have no idea what the direction of the market will be. SaltLight's strategy is to be conservative, patient and deploy capital when there is an adequate margin of safety. My hypothesis when buying our investees is that they have an unfair advantage in turbulence. They're able to pass on price increases to customers in currency depreciation or strengthen economies of scale that competitors cannot replicate. Revenue may slow, customers may delay orders but they will survive and even strengthen their future competitive position.

In this current environment, stocks that have a favourable risk/reward calculus are extremely difficult to find. We own nine businesses and still hold 27% of assets in cash. Some investors refrain from holding excess cash on their balance sheet as it is seen as a 'opportunity cost' or 'drag' on investment performance. This is partially true as cash yields sub-6% whereas equities could yield more than 6% - albeit with the possibility of a capital loss. The opportunity cost argument underlies a very short-term perspective that ignores that cash is king when 'the cannons are firing'.

Our investments are prudent for the current environment. I am quite certain that we will get better opportunities in the future to buy wonderful companies, with excellent management at favourable prices.

Annual General Meeting

Don't forget that the SaltLight's Annual General Meeting will be held on **22 October 2016 at 9am**. If you are unable to attend, could you kindly complete the proxy voting forms and return them to me **by 12:00 on 20 October 2016**.

Sincerely,

David Eborall
Executive Director

[3] Return on invested capital is the investee's return on average capital employed comprising of equity, debt and minorities.