SALTLIGHT CAPITAL

SaltLight Capital
Unit 3 Brookwood, 50 Hyde Close, Hyde Park,
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## Quarterly Update: 2nd quarter for the financial year ended June 2017

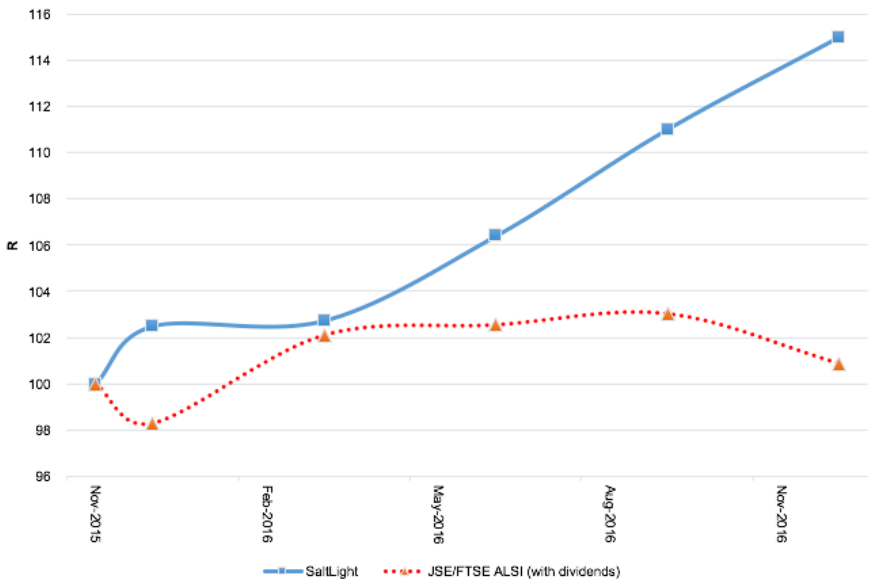
Dear Fellow Shareholders,

SaltLight Capital is an investment holding company that seeks to invest your capital for the long term with the objective of growing net worth[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 Worth Value[1] | In Per-Share Net Worth 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% |
| 2017-Q2[2] | 114.99 | 3.59% | -2.09% | +5.69% |
| Cumulative since inception | | 14.99% | 0.87% | +14.12% |

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. 2017-Q2 represents 1 October 2016 to 31 December 2016.

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




[1] Net Worth or 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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**Report on Operations**

During the quarter, net worth per share grew by +3.59%. As a reminder to shareholders, our financial year operates from July to June. For comparative purposes, the 2016 calendar year net worth per share grew +12.19% vs. the JSE ALSI (including dividends) +2.63%.

You will recall that, SaltLight has two business lines of operations categorised as 'general' long-term holdings and a 'work-out' portfolio that will have a maximum of 20% of shareholder capital allocated to it. Two new investments were added to the 'general' portfolio and one investment was added to the 'work-out' portfolio… and then subsequently sold within a few weeks after a disappointing capital allocation decision by the management of the company.

Overall, activity was a bit higher this quarter as opportunities arose however I do not wish to be this active in the future. As Warren Buffett said, '*activity is the enemy of returns*'. To be fair, I had been researching the new additions for over a year and finally had the opportunity to deploy capital when their entry prices were attractive. I talk about one of the new additions below (see *Mr Price*).

- We now own twelve businesses valued at a discount to intrinsic value and hold 8% of assets in cash.
- Our 'work-out' portfolio has certainly managed to earn its keep, netting a pre-tax compound return of 56% since inception. Candidates for the 'work-out' portfolio usually have a limited risk with high uncertainty. I should warn shareholders that this return is unlikely to continue – *unless there are more Finance Ministers who are fired for irrational reasons*.

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***Mr Price – A New Addition***

In 1986 Stewart Cohen and Laurie Chiappini, at last, had succeeded in buying back 'their' factory store outlets from franchisees. A few years earlier, The 'factory store' idea had been borrowed whilst Stewart and Laurie had seen the concept on a trip to the USA. Their guiding dream from that day was to offer quality merchandise at substantially lower prices in South Africa. However, at first they did not have sufficient capital to open their own stores and so they franchised the concept. The transaction, through the acquisition of ailing John Orrs in 1986, allowed them to execute on their vision.

A few years later, Alastair McArthur was appointed as a professional CEO and was an extraordinary catalyst to growth. He pushed for the name of their stores to be changed to 'Mr Price' **(MRP)**. Since then, the trio have transformed an industry dominated by large department stores to a 'fast-fashion' concept, growing revenue from R30m in 1986 to R19bn in the last financial year.

*1986 or 2016?*

Read any newspaper today and it appears that the political and economic risks in South Africa seem perilously 'capital destructive'. Imagine an investor in 1986; the sunset of Apartheid was approaching and in the prior year, the government had declared a state of emergency with wide powers. *Click* on this chronology of headlines in 1986[2] and consider the environment in which a wonderful business like Mr Price was started. Compare these headlines to what appears to be today's perceived political and economic 'catastrophes'. It reinforces the notion that we should

[2] https://en.wikipedia.org/wiki/1986_in_South_Africa

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heed Ben Graham's foundational principle of buying a business and ignoring macro political or economic forecasts. It's a simple concept, but simply not easy to apply. *Imagine you are buying a private business whilst retaining management. To ensure long-term sustainable returns; (1) have a margin of safety and (2) durable competitive advantages.*

It is quite unlikely that, in 1986, Stewart and Laurie would have foreseen the dawn of democratic elections in 1994, the rise of the emerging middle class and the death of department stores as the primary provider of apparel goods. I'd like to hope that our process would have turned up Mr Price's competitive cost and capital advantages back then.

Mr Price fits neatly into our investment philosophy of 'value creation' for customers, employees and society as a whole. Their primary concept is 'fashion + value'. Not simply offering a product at a low price but also creating perceived value by providing a fashionable product at that low price.

The 'fashion value' strategy is illustrated in this anecdotal evidence: in 1992 Mr Price's competitors sold a pair of jeans at an average retail price of R180.00[3] per unit. Convinced that this was too high, Stewart and Laurie engaged a supplier to engineer a world-class product that was then sold at R49.99[4] – making fashionable jeans affordable to a whole new lower-income customer market. For many, it is difficult to imagine the dignity that new, clean and, above-all, fashionable, clothing brings to a person who has only experienced 'tattered' clothing their entire life. *How does Mr Price compare today?* A similar pair of jeans retails in their MRP store at R199.99 - *22 years later (and more or less at what competitors were selling a pair back then)*! Compare this to Truworths and Foschini who are retailing their products at 2-3x this price[5].

After some deep research, studying 14 years of Mr Price's annual reports and patiently waiting for an attractive price, shareholder capital was deployed to this wonderful business.

Many shrewd investors would raise an eyebrow at the notion of allocating capital to an apparel retailer. History is replete with examples of fashion retailers that have a good run and then eventually end with a tale of a near-death experience or fatal bankruptcy. Astute South African readers of this letter will have 'Edgars' and 'Platinum Group' flash up in their short-term memories. Some of our international readers will look at their December US retail portfolio and vigorously scream out: "*nobody is going to malls anymore!*".

To add further to the bear's case: over the last five years, foreign retailers seeking greener pastures have entered the local market in full fervour. The demand-side 'moat' in a general fashion retailer is usually frightfully thin. In a mall setting, your competitor is prowling *next door* to you! Customer captivity is essentially limited as there is zero friction to buy a T-shirt in your store or walk across to your competitor. Many retailers use loyalty cards and credit accounts to create some switching costs, however the customer's wallet can only hold so many cards and new credit regulations make it harder to open a credit account. Furthermore, keeping up with being 'in fashion' is a hit and miss with each passing season. Customer tastes change either because the next 'new thing' comes along or your customers grow up and change to suits. South African retailers are fortunate in that they are one season behind the Northern-hemisphere and therefore 'fashion risk' is somewhat reduced.

My thesis is that Mr Price is quite different to the rest and that its competitive position will endure. It will continue to benefit from the socio-economic context of South Africa over the coming decades.

[3] R180.00 in 1992 is R847 in today's prices according to http://www.inflationcalc.co.za/
[4] R49.99 in 1992 is R235 in today's prices according to http://www.inflationcalc.co.za/
[5] At date of writing, Truworths advertises denim jeans at R700 per pair; Foschini at R550 per pair on their websites.

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A few key points I'd like to highlight:

- It has a sophisticated supplier-to-shelf engine that competitors will struggle to match without the same scale.
- It has pricing and profitability advantages that allow it to remain the ultimate 'under-cutter'
- It has asset efficiency that will allow re-investment in growing competitive moats and excess capital to be returned to shareholders

*Supplier-to-shelf engine*

In the case of bricks-and-mortar retailing, having the right product, in the right place and the right price is a core competency. The American military general, R. Barrow, once commented that *"novices talk about tactics, experts talk about logistics"*. Modern retailing is unusually similar to a war theatre. The process of moving a product from the supplier to the shelf is acutely reflected in success or failure – primarily in product pricing and profitability. Retailers are heavily impacted by operating leverage whereby a small drop off in sales (for example by excess stock sitting in shelves) has a multiplier effect on bottom line profitability[6]. A few years ago, Mr Price invested in sophisticated systems that anticipate what items needed to be replenished *before* they ran out. This reduces 'missed' sales and optimises product mix dynamically to prevailing conditions (for example, more umbrellas in rainy weather).

Merchandise spends significantly less time on Mr Price's shelves than on competitor's shelves[7]. Each day that a stock item remains on the shelf, it ties up working capital. The quicker the turn from stock to cash, the quicker the retailer redeploys the cash for another sale.

*Pricing and profitability advantages that allow it to remain the ultimate 'under-cutter'*

Retailers also focus on the revenue-generating ability of the floor space that they are using. In retail parlance, this is called trading density[8]. Picture this: open your arms wide to your left and your right; and then widen your arms forward and back. This is approximately a square meter. Consider, that in that square meter, Mr Price will generate turnover of ~R32,000 over a year; Truworths R30,000; Foschini R22,000 and finally Edgars, R17,000. Mr Price is simply getting more bang for its buck on its retail space and leasing costs.

In the context of weak demand-side competitive advantages, supply-side competitive advantages need to be in place to earn high returns on capital. In most retail categories, supply-side competitive advantages are typically limited to local geographies (e.g. Walmart has struggled to match its superior machine outside of the USA).

Any foreign competitor (Zara, H&M, Cotton-on) would have to outlay capital to build capacity to grow its stores and manage its stock efficiently. Consider a well-known international brand such as H&M. It uses 'Apple-like' hype to bring customers through the door, however if their fixed supply-chain cost is spread over 20 stores vs a network of 1000 stores, the lack of economies of scale mean that their distribution cost per item is far higher. A retailer with a lower distribution cost per unit has deep competitive advantages against a bulkier, more cost-laden competitor.

[6] An example of operation leverage is where a 3% drop in sales could result a 10% drop in bottom-line profit.
[7] Despite having some slow-moving products such as furniture, Mr Price turns over its stock every 50-60 days. To compare: Truworths turns their product over every 70-90 days and The Foschini Group 120-180 days a year (*source: company data, SaltLight)*.
[8] Annual retail turnover divided by trading space (in square meters).

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Mr Price continues to invest in distribution centres, cutting out supply chain inefficiencies and using a 'capital management approach' to their operations. The result: wonderful gross and operating margins[9] notwithstanding the retail pricing of their goods being 2-3x cheaper than competitors. In a price war, Mr Price has capacity to compete either by investing in price discounts, more advertising or quality of inputs.

Healthy gross and operating margins are an important component to creating favourable returns on capital, however what is more important is how much capital (denominator) is needed to create returns (numerator). This is where Mr Price has superior advantages.

*Asset efficiency*

Asset efficiency is the component that ultimately benefits long-term value for shareholders in a bricks-and-mortar business. Mr Price only requires 23c of operating assets[10] to generate R1.00 of sales; compare this to Truworths (46c) and Foschini (83c) where their credit books[11] tend to devour operating cash flow and, ultimately, results in lower returns on invested capital.

It is my thesis that Mr Price's combination of cost and capital advantages create strong durable advantages in the face of growing competition. By all accounts, the next few years are expected to be tough for the merchandise sector. Seeing muted growth in the local market, competitors have been allocating their capital to large offshore acquisitions rather than investing in their South African operations. Mr Price has also been dipping its toe in Australia and we praise management for their 'test-concept' approach. As I mentioned above, supply-side competitive advantages are usually restricted by physical geography. Therefore, any headwinds foreign retailers face entering into South Africa will be equally faced by Mr Price entering into Australia. It will take a long time to replicate the 'engine' that have here – however if they succeed, the business has a large addressable market to conquer.

Our favourable entry price allows for a tougher domestic market scenario and a likely outcome of 'slower-than-expected' international expansion to still earn an appropriate return on our capital. Any better-than-expected outcomes will be ice cream and sprinkles on the cake.

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I wish all our shareholders a wonderful 2017. Thank you, as always, for your support and long-term vision for this business. Net worth per share has grown every quarter since inception. I would caution shareholders that they should not expect this to always be the case.

My focus is on the long-term and I am encouraged that the wonderful businesses that we own will continue to deliver excellent returns for shareholders over the coming decades.

**Sincerely,**

**David Eborall**
**Executive Director**

[9] Mr Price's operating margin is 19%(gross margin: 41%-42%); Truworths 25% (gross margin: 55%) and Foschini 14% (gross margin: 50%) *(source: company data).*
[10] Operating assets comprise of working capital and fixed assets excluding goodwill, deferred tax and derivatives.
[11] Mr Price has a policy to limit credit sales to 20% of total sales.