SALTLIGHT CAPITAL

SaltLight Capital
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Quarterly Update: (March 2017) 3rd quarter for the financial year ended June 2017

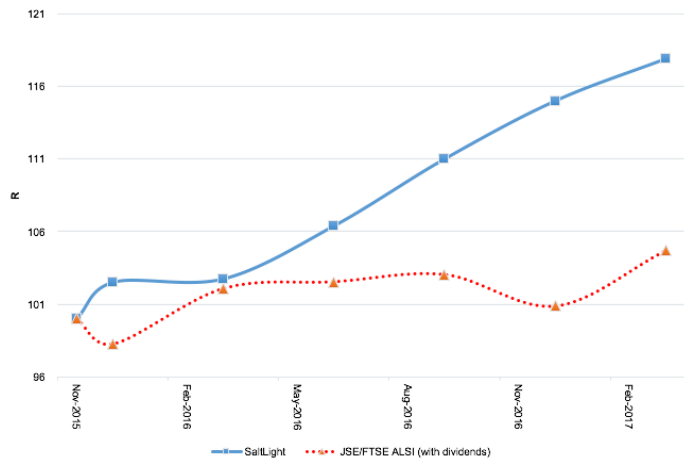
Dear Fellow Shareholders,

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%
2017-Q3[2]	117.89	2.52%	3.78%	-1.25%
Cumulative since inception		17.89%	4.68%	+13.21%

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; 2017-Q3 represents 1 January 2017 to 31 March 2017

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 +2.52%** relative to the JSE All Share index (incl. dividends) of +3.78%. As a reminder to shareholders, our financial year operates from July to June.

What a difference two weeks can make! Our quarter period end was 31 March and the day before, President Jacob Zuma reshuffled his cabinet, removing Pravin Gordhan as Finance Minister. As the market reacted to the news and re-assessed the implications for the economic outlook, many of our holdings felt the sting of a hasty 'sell order'[2].

Coinciding with the events of this week, I was due to start a US trip to talk about the prospects of investing in South Africa and how SaltLight operates. Whilst waiting for my $3 latte and reading about reactions back home, I felt some sympathy with Harold Macmillan when he was asked to what he attributed his biggest problems. He swiftly replied, "*events, dear boy. Events*".

As previously written, SaltLight's investment philosophy is decidedly 'bottom up' and focuses on value at the business level. It is my opinion that figuring out how to make capital allocation decisions based on macroeconomic and political factors is extremely difficult. Firstly, the correct outcome needs to be forecasted. Secondly, based on a correctly-predicted outcome, a capital allocator needs to have the right investments that move in sympathy with the outcome. Focusing on the company and industry structure is a far better use of time and generator of long-term returns.

Therefore, this quarterly update letter shall be devoid of political speculation or rehash the events that have been well documented in the press. I will use every ounce of restraint to not quote Buffett or the Stoics to give meaningful assurance that all will be okay. *Let me be upfront to acknowledge that I do not know how macro events will unfold over the short-term*. From a value investor's perspective, wonderful opportunities emerge in perilous times to deploy capital at attractive prices. As a reminder, my criteria for deploying capital in <u>any environment</u> is 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;
(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.

Our investees are not immune to the vagaries of the macro economy. In some cases, a rise in bond yields directly impacts the cost of doing business (as we own a bank and have exposure to insurance companies). Market quotations for these businesses have declined somewhat as events have unfolded. Investees with debt will pay more interest and those with exposure to lower income customers will likely see a drop off in demand.

My investment process has a significant component of risk analysis principally comprising of "stress testing" the business under difficult scenarios. In many cases, I have passed on wonderful businesses where the acquisition 'price' does not adequately compensate the investor for these stressed scenarios. Ben Graham referred to this as a margin of safety. Shareholders should remember that the price you pay often compensates for many of the negative headlines over time.

[2] Accounting rules dictate that we 'mark' our positions to the final closing quotation on the stock exchange. This happened to be on the day markets could react to the political events as they unfolded.

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Much of my effort this quarter has been spent on reviewing my primary research on our investees. Whilst difficult, I aim to ascertain whether events or data since deploying capital, confirm or disconfirm the original investment theses.

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Now that we move away from fear of the unknown, I would like to move to what we do know. Most of our investees have reported either interim or full year results this quarter and the results have been encouraging in a difficult environment. I have added to positions where there is still an opportunity for an adequate return on capital available. I have sold one investee in our 'workout' portfolio where the thesis played out sooner than anticipated. The primary purpose was to raise some cash for further opportunities (see Rolfes below).

Here is a brief update on a few of the businesses that we own:

Trellidor Holdings

In my June 2016 and 1Q16 letters I gushed about Trellidor Holdings. Trellidor has been a significant contributor to our growth in NAV this year. In my previous letters, I noted that Trellidor had acquired Taylor Blinds at a wonderful price.

- Trellidor released their half-year results during the quarter with the Taylor Blind's business included for the six-month period. Profit after tax grew 31%; mostly attributable to the acquisition that was funded from debt and cash on hand.
- From a group perspective, international sales (mostly to African countries) now comprise of 16% of turnover.
- Taylor has marginally softened Trellidor's gross margins from 50% to 48% and reduced EBIT margins slightly.
- Management's capital allocation decisions are important from a shareholder perspective as one of two scenarios can happen: (1) the company pays excess capital back to shareholders in the form of dividends or buybacks and then the shareholder would need to make an appropriate decision to earn an adequate return on that capital or 2) management retains the capital and it reinvests it in growing competitive advantages or deploying it to rational acquisitions. Trellidor paid a 5.7x historic PE for Taylor, currently management is on track to earn a 22% return on that incremental capital.
- Terry Dennison and his team have done a wonderful job and margins should improve as the acquisition is bedded down.

I have increased our position slightly this quarter.

Howden Africa

In my 1Q17 letter, I alluded to Howden Africa and wrote about some of the issues 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 [update: on date of writing, this is currently R31].

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;*

Howden released FY16 results during the quarter with a surprising increase in revenue (+8%). This is after management had been extremely cautious about their order book at their interim results. The scenarios above remain as potential outcomes. The one notable point is that the margin of safety attributable to Howden has been significantly growing (1) due to strong competitive advantages and (2) by a very strong balance sheet. In the extract above, I mention that cash roughly represents R8 per share and after these results it now represents R11/share (roughly 35% of the market capitalisation). This is a very strong margin of safety for a quality business. Further channel checks in my research also bring additional comfort to my thesis about Howden's competitive position in the market.

Rolfes Technology Holdings

Rolfes has been a smaller investment in our workout portfolio since May 2016. It is a specialist chemical platform business operating in food, agriculture and water sectors.

- The deployment of capital to Rolfes is a good example of pricing inefficiencies that occur some of the less well-lit corners of the JSE (quietly dispelling the academic theories of Efficient Market Hypothesis[3]).
- Rolfes had been slowly transforming itself over the last few years after several poor acquisitions of businesses with weak competitive advantages.
- Since 2015, fresh capital and a more rational capital allocation strategy led the company to wean off low-margin, high-effort divisions and to retain businesses with moderate competitive advantages.

[3] https://en.wikipedia.org/wiki/Efficient-market_hypothesis

- Recent price weakness was a result of the prolonged drought in the agriculture sector which 'dried-up' demand from their customers.
- At the time of capital deployment, Rolfes announced an acquisition of a food chemicals business called Bragan Chemicals. Bragan's historical earnings were provided to the market prior to our acquisition.
- Bragan has a typical working capital business model where capital is predominantly deployed in inventories and debtors. If the working capital turns over quickly, returns on invested capital can be well above the cost of capital. Bragan had high returns on capital and Rolfes had paid a premium to book value to acquire the business.

The investing 'equation' is part returns and part probability. High returns (50%) with low probability (10%) are the same as high probability (50%) of low returns (10%). What is required is that various scenarios are explored using probability and expected return outcomes.

- *Scenario 1:* Without Bragan in Rolfes' numbers, Mr Market was offering Rolfes at a slight premium above earnings power value that assumed the current depressed earnings (due to the drought) would continue forever (*low probability*).
- *Scenario 2:* If there was a recovery from the drought (back in May 2016, this was not clear) and earnings return to 'normalised' levels, Rolfes was trading at an adequate margin of safety (*high probability*).
- *Scenario 3:* Once the historic earnings of Bragan were included in assumptions, Rolfes was statistically *very* cheap and therefore had significant upside (*moderate probability*).

Based on the announcement of the Bragan acquisition and that it had been successfully closed, 'scenario 3' had a very high probability of occurring. Bear in mind, that all the information was available on the company's website to figure this out. However, because Rolfes has a smaller market capitalisation, it is not well followed by sell-side analysts or large investment houses. This is pure market inefficiency.

The discount to intrinsic value narrowed substantially over the last ten months to earn a 92% return on capital. The discount to intrinsic value still exists however over the long term, Rolfes' businesses do not earn substantial returns above cost of capital. For this reason, Rolfes does not warrant being added to the 'generals' portfolio and I decided to rather exit with a healthy return to deploy capital for fresh opportunities. *I do not anticipate most investments to realise value this quickly over time.*

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We currently own 11 businesses and retain 12% of assets in cash ready to be deployed if further value opportunities arise. I would caution shareholders, that since quarter-end, there have been moderate declines in quoted prices on some of our investees – this may result in SaltLight's first negative quarter in June.

As always, my investment outlook is for longer time horizons of five to ten years. The factors that matter most in this outlook are (1) industry structure (2) competition (3) management. General economic conditions will vary over time across cycles (right now we are in the 'going slowly nowhere' cycle).

Looking ahead ten years, we will probably have had one or two new presidents, and three or four new finance ministers. The changes in industries and companies with unfair advantages vary much less over time. Reflecting back to ten years ago, consider that Facebook was three years old; the iPhone had just been launched; the Global Financial Crisis had not yet started and George Bush was wrapping up his second term in office. So much can happen in a decade.

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I am decidedly bullish about South Africa and the future opportunities that lie ahead. Whilst political noise can skew the short term positive bias, I believe a disciplined value investing philosophy will yield positive above-average returns over the long term for shareholders.

I'd like to remind shareholders that most of my liquid investments are in SaltLight and bear movements in any ups and downs on the same terms as yours.

I look forward to the final 4th quarter for the year-ended June 2017. As always, please do not hesitate to get in touch if you wish to discuss anything.

Sincerely,

David Eborall
Executive Director