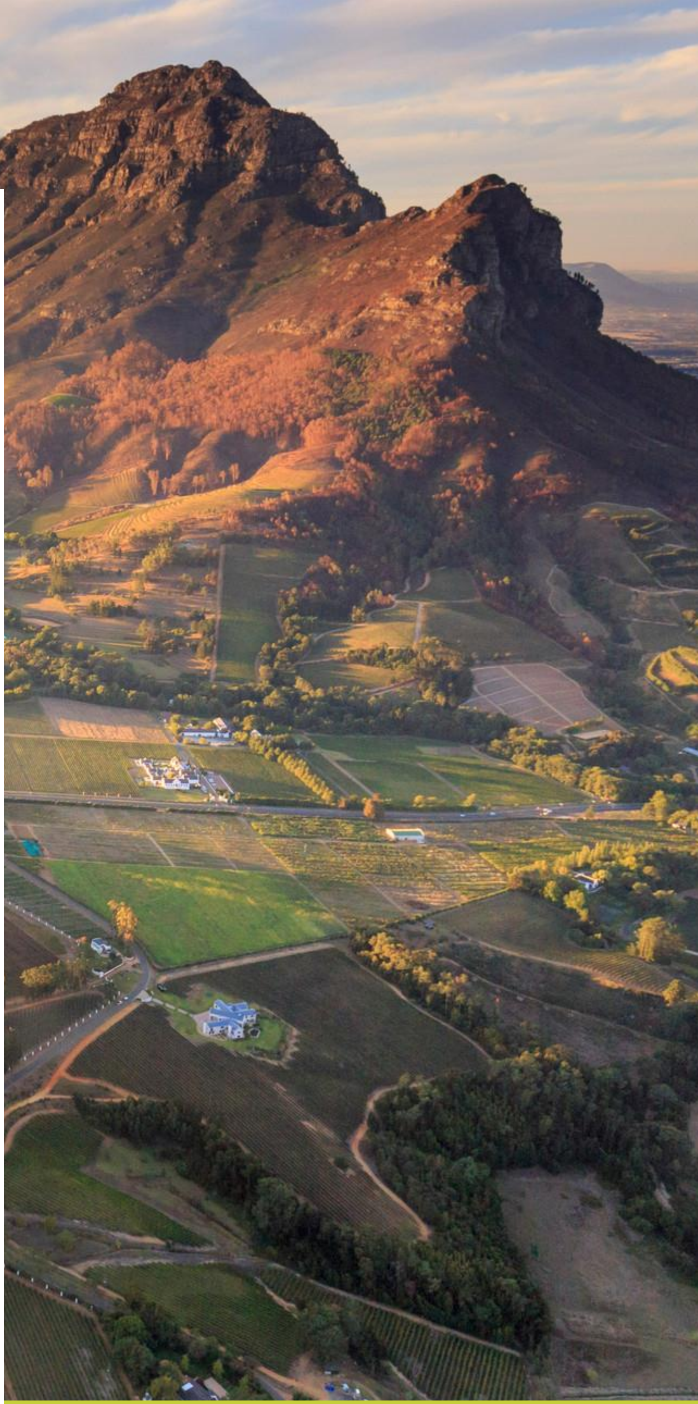
Vineyard Holdings

2020



APRIL 2020

JORDAN NEL

23 April 2020

Dear friends,

This is the first of what will hopefully be many such letters. I will be brief; I intend one day to open and manage a fund dedicated to the below:

> *It will be a closed-list fund specializing in local, Sub-Saharan impact-based & ESG-promoting equity positions. This fund will be aimed at creating shared value, both for shareholders and the community at large, and enabling local enterprise. It will be neither industry nor size specific (funds permitting), but will be weighted largely with African stock, or stock which benefits Africans.*

My capital allocation approach is simple and has been used by a myriad before me. It will be drawn majorly from the likes of Buffett, Munger, Pabrai, Spier, Graham and Greenblatt, all powerhouses in their own rights. In their works I've found much inspiration and sense-making of an industry regarded with such widespread skepticism.

Regarding the management of the fund, I will not be accepting any funding until I have a proven track record of 16% compounded annually for a period of at least two years with my own money. Over this time, I intend to send out many of these such letters – whether monthly, quarterly or bi-annually I have yet to decide. I will follow in the footsteps of Pabrai and the Buffett-Munger Partnership and decline management fees, taking only a percentage of the profits above the 6% hurdle rate net of inflation.

Each letter will contain several thoughts on investing, capital allocation and management (fortunately, these thoughts will be brief and concise). Further, it will contain a brief review of several stocks I find worth considering – I intend for these to be nuggets for the enterprising reader, no more – a review of the fund's performance and a book recommendation. Exactly the sort of thing I would like to read. Below is the first of such reviews:

The fund will begin with a R23 000 of my own funds, with around R3000 being deposited monthly over 8 months for a sum of R47000 at the end of the year, excluding returns.

The stocks under consideration here are Curro Holdings (COH), African Rainbow Capital Investments (AIL) and the Lewis Group (LEW). The following page details my thoughts. In addition to these, I have attached a summary of the company profiles according to the value investing databank *Gurufocus.com*.

African Rainbow Capital Investments Limited

Growth purchase at a value price. The firm invests primarily in low-cost innovative early state companies. Differentiated value proposition is BBBEE discount and synergies across network of investments.

- **Pros:** trading at R3.25 with intrinsic Net asset value being approximately R9.5. If you deduct the usual 20% discount holding companies often trade at to their NAV, you still end up with a discount of 57% to NAV. Strong growth prospects with TymeBank and rain both meeting onboarding milestones.

- **Cons:** Little track record for revenues. Predominantly young, unproven companies. Heavily exposed to financial services. Trying to start new companies (Rain & TymeBank) in a very tough economic environment.

My view is that the market is currently over-estimating the challenge faced by new companies in a tough environment and is creating undue downward pressure on the stockprice to the neglect of the existing growth metrics achieved by Rain & TymeBank. This creates buying opportunity, as even if the companies in question were written off entirely, the NAV of the stock would still be above market price Further, the decreased stock price limits downside sufficiently to provide an adequate margin of safety.

Curro Holdings

A hard pass from me. Initially appealing, given the extensive need for education facilities in South Africa and the appealing economics of the business, however a closer look into the capital allocation by Curro's management has made it a strong no from my side.

- **Pros:** Predictable revenue and exponentially increasing earnings as schools mature after initial capital outlay. According to Curro's most recent AGM, if they stopped acquiring or developing new schools today and just let their current school base reach maturity, revenue would grow 70% but earnings would grow by 351% (without factoring in annual price increases which are slightly above inflation).

- **Cons:** High leverage required to fund further growth/school development (as expected from an education company). Management has to-date achieved returns of between 0 and 5% on equity, assets and invested capital. These are all below the weighted average cost of capital which has averaged 8.3% over the past 10 years, with 2019 ending at 11.96%.

Per small cap fund manager Kieth MchLachlan: "Curro's current returns are too low to justify the capital it is deploying. In fact, its returns are even lower than its cost of debt and, thus, the more Curro builds, the more shareholder value the Group destroys.". This combined with the large amount of leverage makes it an easy pass for me.

The Lewis Group

Another hard pass. Although undervalued on almost all possible accounts, this is a stock I will not want to hold for very long, again due to the very low returns achieved by management. I expect a brief rebound in prices in the short term, but how much and over what time period I do not know, nor am I interested.

- **Pros:** Trading at very depressed prices (PE: 3.47; PB: 0.22; PS: 0.28) despite sitting in a comfortable financial position and having reduced debt levels significantly in the last 3 years. Has good cash flow levels and strong current earnings yields. While credit regulations are increasingly stringent for lower LSM targeting companies, courts have repeatedly judged favorably for Lewis in both credit and competition-based litigation suits.

- **Cons:** Declining margins and revenue are indicative of a shrinking or non-existent "moat". Further, paltry (and decreasing) returns on equity and assets indicate a subpar allocative ability of management.

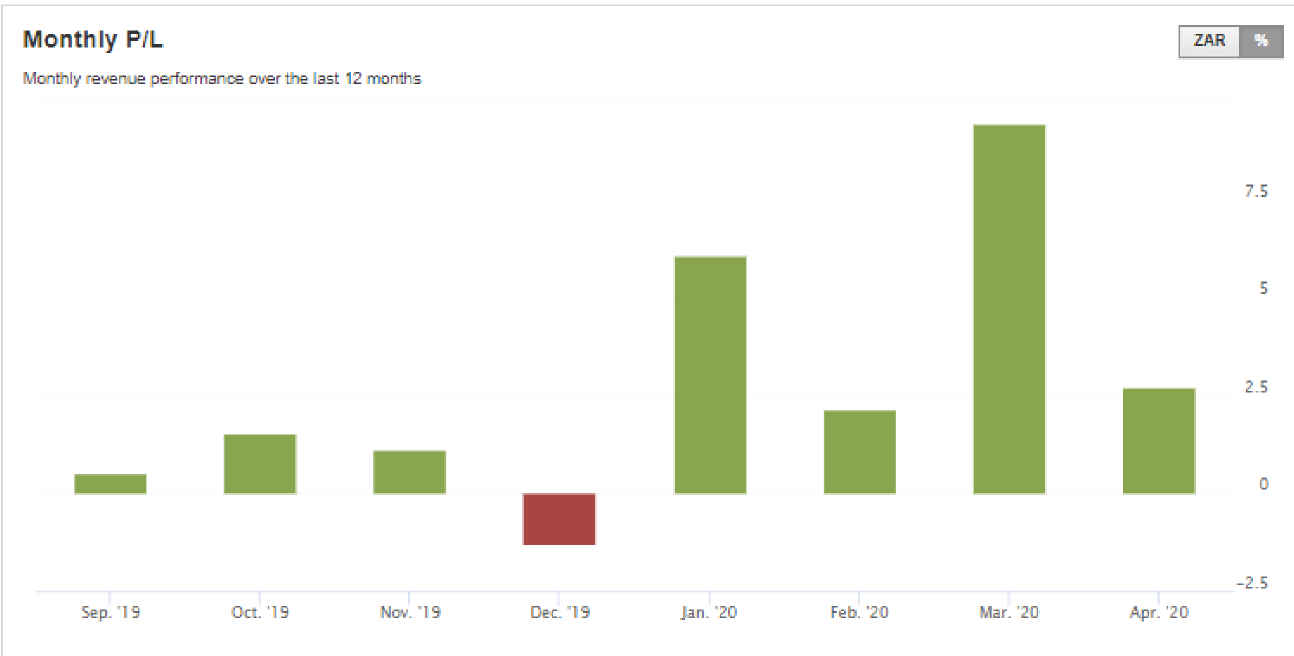
Ultimately, despite a strong cash position and enticing valuations. the financials here do not indicate a company growing from strength to strength. South African equities offer many a bargain for the diligent seeker, particularly in the wake of COVID-19. However, in the often-quoted wise words of Charlie Munger: "A great business at a fair price is superior to a fair business at a great price".

Company summaries below.

JSE.COH.pdf JSE.LEW.pdf JSE.AIL.pdf

Review of the Fund’s performance

Please note, the fund has not been in operation for long, and as such, the below is not necessarily a good indicator of future performance. I would advise looking again in a year’s time.



Market Value: **R26,965.74**

Open P/L: **R3,200.73 / 13.52%**

Book Recommendations.

1. *Education of a Value Investor* by Guy Spier*:* An astoundingly good book filled with gems. Guy is a very fluid and relatable writer who speaks well to those who are just starting out their journey. Speaks very well about the irrational part of the brain and the need for a) an understanding of behavioural finance and b) the need to create a structural advantage around you.

2. *Thinking, Fast and Slow* by Daniel Khaneman: Incredibly valuable book. Probably one of the most quoted books I have come across by other authors I have been reading. Khaneman does an outstanding job of outlining System 1 vs System 2 thinking and unpacks all the biases we are prone to when making decisions. It is important to carry a list of these biases close at hand at all time and refer to them whenever a big decision is made. I have personally incorporated such a list into my investing checklist.