# Vineyard Holdings 2020

**OCTOBER 2020**

**JORDAN NEL**

# 19 October 2020

| | Vineyard Holdings (ZAR) | S&P 500 Index (USD) | JSE All Share Index (ZAR) | MSCI Emerging Markets Index (ZAR) |
|---|---|---|---|---|
| Since Inception | 45.18% | - | - | - |
| 2020 (YTD) | 45.18% | 7.70% | -4.51% | 21.31% |
| Total Annualized Return | 45.18% | 7.70% | -4.51% | 21.31% |

*Figure 1: Annualized returns for Vineyard Holdings not accounting for currency.*

Dear friends,

Thus far, 2020 has brought many lessons with it. Some of these lessons have been learned first-hand (painfully), and others vicariously (through quite a bit of study). Barring lessons, some highlights from the year include:

a) A return-to-date of 45.18% since the Fund's inception in September 2019 and,
b) The beginnings of saequities.com – which I use to share company reports, fund updates and general musings.

This is my second such letter of this type. Its purpose has evolved somewhat from April of this year – the time at which I released the Fund's 2020 Q1 performance. In the earlier letter I laid out my plans for the Fund, gave lip-service to several inspirational investors, and provided a high-level overview of a couple companies I was considering at that time. Ultimately, I passed on all three, but not after burning my fingers on African Rainbow Capital (which I will cover later in this letter).

This letter, however, will simply provide an overview of the Fund and my thoughts around how it will be operated going forward. Afterwards, I will comment briefly on lessons 2020 has taught me and will – as always – end off with a couple book suggestions.

As before, I will not be accepting capital from outside investors for a little while yet.

## Review of the Fund's Performance

The Fund has performed well over the last year, due in no small part to our large stakes in Cartrack and Balwin Properties, which together comprise nearly 40% of the Fund's total equity position (Figure 2).

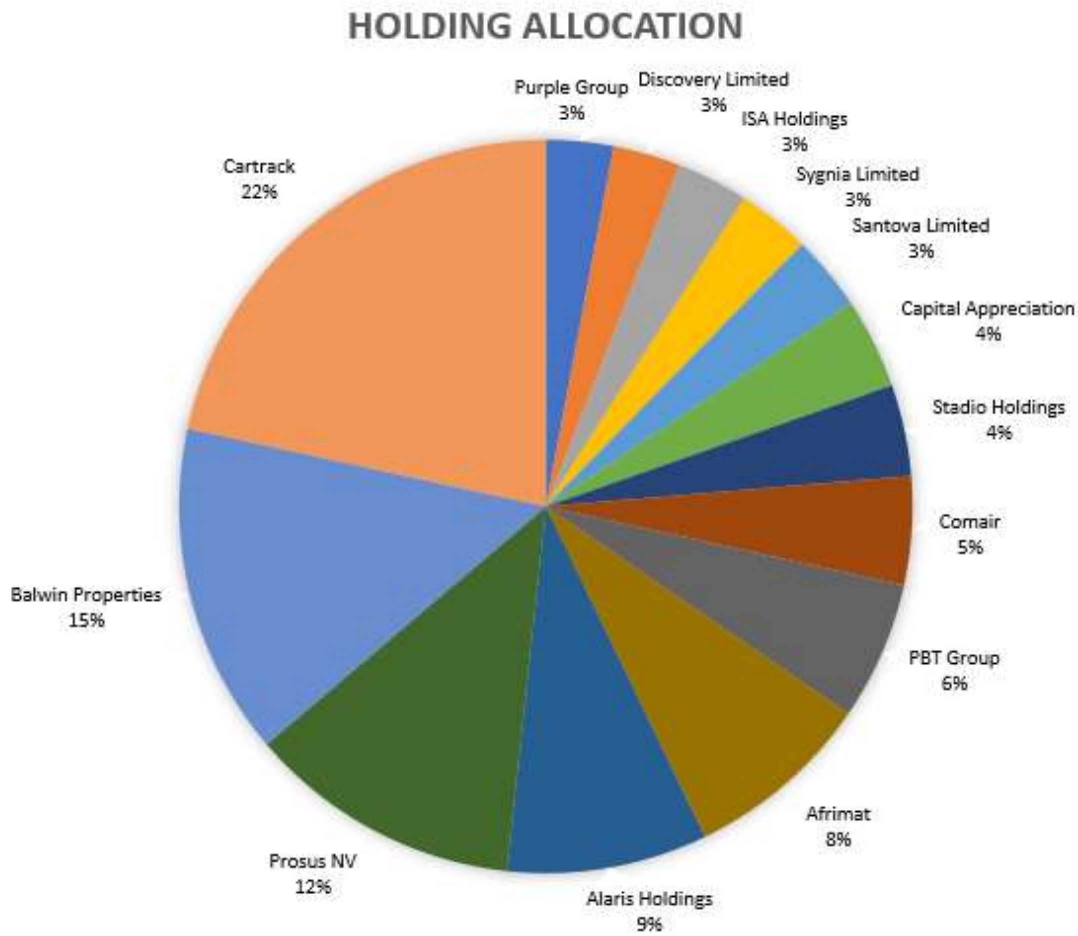


*Figure 2: Equity holdings in October 2020.*

There are two primary considerations when managing a Fund: what to invest in, and how much to invest in it. All else can be categorized into these decisions. From a "how much" perspective, one must think about how both to preserve and grow capital. From a "what to" perspective, the question is simply around growth. In today's rapid change, high uncertainty environment, a portfolio should be structured to capitalize on a broad range of outcomes and not rely on predictive capability. This is where portfolio management plays an increasing role.

Investing is non-ergodic, fat-tailed, dynamic, and complex. Trying to predict things is hard. My approach then is to barbell a strategy between Resilient companies, and those with Optionality. Resilient companies are cash flush, low leverage, and businesses with a narrow range of outcomes. They do not require many narrow predictions to be right - Balwin is a good example. Optionality businesses are those which provide positive asymmetry in their pricing: They face uncertainty now, and require narrow predictions, but exhibit characteristics that expose them to substantial upside. The Purple Group (owner of EasyEquities) is a good example here.

Some businesses – like Cartrack and Prosus – offer both Optionality and Resilience. They are stable and established industry leaders, who exhibit significant potential for growth and have entrenched competitive advantages. Roughly 80% of the portfolio is in companies displaying substantial resilience. The remainder is in Optionality-only companies.

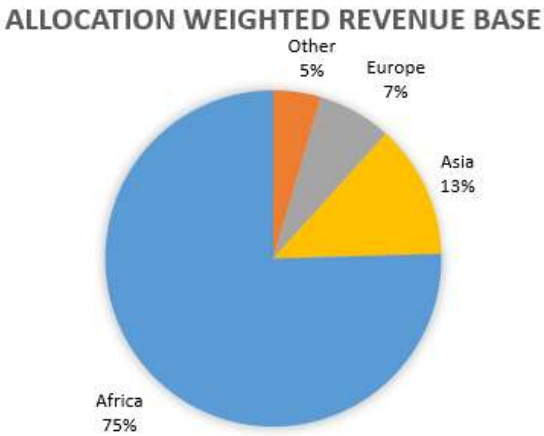


*Figure 3: Vineyard Holdings weighted revenue base.*

One of the primary concerns with a South African exposed fund is the ZAR denomination of its assets. The coronavirus has hit emerging markets especially hard, and there is justifiable concern around currency risk. Figure 3 shows the "rand hedge" of the Fund's underlying companies.

Hedging the ZAR in a South African fund by buying companies which draw revenue offshore is only so useful though, as an implicit bet in buying South African equities at all is that you believe they will do better than equities elsewhere.

I believe investors have underpriced South African mid-to-small cap companies at large, and these companies will experience re-rated multiples over the coming years. Many of these companies are trading at multi-decade lows, and several are truly world-class companies. Considering that not many people are "fishing" in the South African small-to-mid-cap market, there is deep mispricing to be found in this structurally inefficient pool.

From a final portfolio management perspective, the Fund holds ~6% of its Net Asset Value in a basket of cryptocurrencies as a hedge against both the Rand and broader monetary policy. The Fund also holds a large cash account which is used for arbitrage and short term hedging purposes – this account has yielded equivalent to the equities position over the year, so I do not believe this inhibits returns at all.

From a "what to invest in perspective", I am in the early stages of my investing career and am comfortable with the fact that this approach may change in years to come. For now, to quote Munger:

*"Basically, all investment is value investment in the sense that you're always trying to get better prospects that you're paying for."*

There are myriad ways to make money in the stock market. John Biccard of NinetyOne is famous for his "deep value" plays – basically average companies trading at way below average prices. These are not buy-and-hold type of plays, these are buy-and-sell-when-the-market-realizes-it's-overly-pessimistic type of plays. They can be highly profitable if timed correctly, but as yet I do not feel comfortable with this kind of deep value – it requires too much precision on timing for me.

Fundamentally, it is high-quality, simple, and growing companies at margin-of-safety prices that I am looking for. Each company should have a unique thesis for being a multi-bagger in the coming years and should fit into the above framework of Resilience and Optionality. I am looking for companies where the market is mispricing a particular outcome and in industries which I can understand. These companies should add more benefit to their customers, suppliers, and employers than they extract, and they should also be industry leaders in a growing market.

This is a demanding set of criteria, and such companies usually command demanding prices. Finding these companies requires looking then in places where and times when these companies are not looked for; like in South Africa during a global pandemic.

For many in the current zero-rate environment globally, a dollar today might well equal a dollar in five years' time. Decreasing interest rates over the past decade have served to inject continual liquidity into capital markets and (*inter alia*) as a result companies have been valued using discount rates of virtually nil. This trend has substantially increased because of the quantitative easing this year. An outworking of this has been a secular trend towards "narrative stocks" which will assumedly generate outsized earnings in the future.

Recent years have also been hallmarked by the rise of cloud-enabled computing, machine-learning and data analytics, and now a rapidly digitized post-pandemic environment. The result of this is a secular re-rating of many technology companies in estimation of their future growth and dominance. It is difficult to call this re-rating a "bubble" as it is sustained both by actual cash flows in underlying companies (unlike in 1999) and by the low real interest rates (lowering investor alternatives).

That said, such high prices do mean it is unlikely future returns will be as high as they were in the previous decade. For my money, the US tech market is priced for perfection, and such high valuations warrant careful treading. I believe investors will increasingly look to alternative markets for returns. Currently South Africa's companies – those growing, and high-quality – are still well priced to offer these returns and will provide investors with appealing geographic diversification.

## Fund Outlook.

A brief comment on the Fund's positions:

- **Cartrack:** A best-in-class telematics company which offers B2B and B2C data analytics software-as-a-service. Scalable and growing internationally with a long runway, I believe this company will continue to compound ~20% per annum for the foreseeable future.

- **Balwin:** A well-run residential property developer with a deep pipeline and best-in-class properties and location. Trading earlier this year at deep discount (R2/share) to NAV (~R9/share). At present I do not believe there is immediate upside given its recent 100% rally, but over the next 5 years it would not be surprising to see this company triple in size.

- **Prosus:** A bullish play on China (growing market for high-end products) and Tencent (industry leader in social media and entertainment with deep moats). Currently trading at a 30% discount to its Tencent stake alone (70% of portfolio), it carries optionality in its high growth alternative assets.

- **Alaris:** A niche-dominant and resilient company who has shown strong growth (FCF at 29% annualized) over the last 5 years. They have 21% of the market cap in cash and – assuming zero growth – will make back their market cap in free cash flow within 4 years. I expect them to double within 2 years.

- **Afrimat:** They have a history of acquiring and turning around distressed mines. They have superb management and have recently acquired more operations at COVID-depressed prices. In the short run, I expect the rising iron ore price and construction tailwinds to boost profits over 2021-2022. In the long run, Afrimat's diversified operations and managerial acumen make them a resilient stalwart.

- **PBT Group:** A B2B data analytics consultancy servicing top tier local companies. Highly cash generative with industry-leading metrics (ROIC at 17%), they can make their market cap back in free cash flow in three years assuming zero growth. Given the tailwinds in the data analytics industry, it is likely their increased growth rate will both improve earnings and trading multiples in the coming years.

- **Stadio:** One of two tertiary distance education providers in South Africa. They are likely to experience industry tailwinds as disruptors to traditional university models are aided by COVID. Despite being an early stage business, it is cash generative and led by a strong management team with deep industry experience. Assuming they continue to meet their conservative revenue targets and continue to trade on a Price earnings of around 15 (currently 18), they will return at least 5x by 2026.

- **Capital Appreciation:** A cash-flush SPAC, they are the industry leader in Point of Sale (POS) devices and in AWS cloud integration. They have a sticky B2B service model which is entrenched in client's payment systems which generates consistent revenue. However, the POS industry is very prone to disruption – particularly given COVID's effect. Their primary optionality is in their cloud integration services and their increasing self-cannibalism in driving alternative payment fintech through their existing POS distribution channels.

- **Santova:** A tech-enabled logistics company – they outsource most of their actual transportation and provide clients with a comprehensive platform. Their capital-light tech-focus makes them scalable, they have global industry leading margins, and they have grown all metrics between 10-35% annually for 8 years. They earn 65% of their revenue offshore, have stable cash reserves and can make their market cap back in cash within three years.

- **Sygnia:** The industry leader in South African passive asset management with a long runway for growth. They are far more scalable than all incumbents, offer superior products at lower costs, and are likely to experience the tailwinds of increased passive management adoption as local investors follow international trends. They could reasonably triple within the next 5 years.

- **ISA Holdings:** A one-time market leader in cybersecurity servicing the financial sector. I recently reduced the Fund's position in ISA, having taken a profit of 70% since March lows. The optionality is in a turnaround play for the company – they have recently switched from a key supplier to alternatives driving the share price down unsustainably. They hold an optional position in the fund on the prediction that their high-quality management team and industry relationships can restore them to their niche dominance. This would result in a 2-3x return over 2-3 years.

- **Discovery:** A data-driven industry leading health insurer that is a household name for many. The market is not pricing in their growth in China's fragmented insurance market, nor their cross-product integration and their large data pools they have acquired on their customers. They have switching costs and high moats with a long runway for reinvestment over many years.

- **Purple Group:** A rapid growth fintech platform offering DIY investors access to market. Their platform is first-in-class and is disrupting incumbents in both South Africa and Australia. Their recent deal with Capitec will enable widespread distribution and should they secure a Telco partnership, they

> will have dominance over the South African (and later African) market. They have a long runway of geographic and product expansion, and they offer far more to customers than they extract.

I believe the companies selected are high quality businesses with strong growth prospects both individually and in their industries. They are bought at low valuations and I am happy to add to them from the Fund's deep cash reserves should their prices drop further. It is unlikely COVID will detriment them extensively as most (barring Afrimat and Balwin) can be run effectively remotely. They all have very strong balance sheets and none (barring perhaps Sygnia) will be threatened unduly by an increase in default rates. It is possible Discovery will have to pay future illness-related claims out, but they have made reserves available and are in a comfortable position to do so.

Overall, I am optimistic about the Fund's positioning. I am even more optimistic about its purpose:

*To curate, nurture and build an ecosystem of wonderful businesses creating shared value for Africa.*

In light of this purpose, it is possible this fund will ultimately move towards a private equity and venture capital approach as it grows – it would appear to me the natural extension of what will ultimately be a light-touch holding company – but for now this move is still in the distant future.

## Lessons Learned.

2020 has been a hard teacher. Foremost I have learned the value of having liquidity available in a market crisis, and the dangerous tricks that your own sentiment and psychology can play on you. No doubt I will continue to learn these lessons in years to come.

My first mistake (and one I have literally not finished paying for) was to invest into a situation I did not understand. When buying into Comair, I bought into a situation that was out of my circle of competence. I have not the foggiest idea around distressed airline companies and their liquidation proceedings, nor did I do the proper due diligence in understanding their debt covenants. I also bought in on the expectation SAA was bound for liquidation – something I had no more than a suspicion of. The new management was untried, and the company has ultimately gone into business rescue – the Fund's holdings will be diluted to zero when Comair flies again on someone else's money.

My second mistake – which I have fortunately sold out of completely at 10% profit – has theoretically yet to prove itself as a true mistake. I bought into African Rainbow Capital earlier on in the year on the thesis that it was trading way below intrinsic value (NAV was R10/share, share price was R2.8, I estimated intrinsic value around the R5-6 window) and that the underlying assets were potential disruptors in their industries. I still believe the latter – TymeBank is looking very good. However, I neglected to inspect management's incentive structure. Management were paid based on NAV (which they reported) not share price. When management tendered a right offer below the share price (to raise capital to pay management fees) this was both value destructive for the shareholder and suggested a deep structural misalignment of incentives. Management were taking what was effectively 7% of the market cap in annual payments while shareholders were rewarded with nothing.

Both experiences have been painful (Comair by far the more costly) and I have integrated their lessons into a checklist through which I filter investment decisions prior to making them.

## Book Recommendations.

*"A truly good book…teaches me better than to read it. I must soon lay it down and commence living on its hint. When I read an indifferent book, it seems the best thing I can do, but the inspiring volume hardly leaves me leisure to finish its latter pages. It is slipping out of my fingers while I read…What I began by reading I must finish by acting."*

- HENRY DAVID THOREAU

And so, we arrive at the final part of this letter. I have enjoyed writing it, so I hope you forgive the waffling – it has been a pretty spicy year. I have set myself a goal of reading 60 books a year, and this year the two I am most prone to recommend are *Poor Charlie's Almanack* by Peter Kauffman, and *Antifragile* by Nassim Taleb.

Kauffman's book is a collection of essays, speeches, and notes from, by, or about Charlie Munger. Besides its excellent unpacking of a mental-model approach to thinking, it is really just a well-written book. It reads like a scrapbook someone has pieced together to give you insight into one of the sharpest minds of the last century. Kauffman has done a very memorable job of interweaving stories about Charlie – so you get to know the man – with stories from Charlie – so you get to know how he thinks. I believe the framework Charlie built over his life to be one of the most robust, hard-to-learn and yet most immediately useful for the early investor. A must read.

I am a big Taleb fan. His work on probability throughout the Incerto series (of which I believe *Black Swan* and *Antifragile* are the most important) is directly challenging to so much of the financial world. He challenges the idea that events in the real world are normally distributed like those bell curves we learned in high school. He suggests instead that the world is governed by freak events and is entirely unpredictable. Yet all is not lost – he teases the reader – instead one can learn to take advantage of these freak events and to profit from the volatility so common in life. Taleb is a cantankerous man with an excellent mind, and those two traits make him for flipping engaging reading.

The Biblical narrative of Job paints a story of a man arguing with his friends for pages on end. The completely innocent Job – beset by all kinds of trouble – feels that he ought to understand his circumstances. He argues that God ought to explain to him how and why things have ended up this way. Job's friends believe that Job is being punished for his sin and should not challenge God so. Both parties believe that there is order to the world: right is rewarded and wrong is punished.

In the end of the book, God answers both Job and his friends with the question:

"Who is this that obscures my plans

with words without knowledge?"

God goes on over three chapters to challenge Job's understanding of the host of factors that go in to running a universe. He shows Job that there are considerations so far beyond his comprehension that Job's question – as self-focused and short-sighted as it is – is missing that crucial element of humility that underpins understanding.

This simple challenge remains with us today. Decision-making under uncertainty requires massive amounts of epistemic humility. Knowledge begins outside us; we cannot make good decisions until we realize this and humble ourselves accordingly. All considered 2020 has been a sobering year, but the future is bright, and we have made good progress. The Fund has taken its infantile steps and I look forward to what is to come.

Warmest regards,

Jordan Nel.