



Rozendal Partners Investor Letter 31 December 2019

Dear friends and fellow investors,

Rozendal's performance vs. benchmark

Period	Fund*	Benchmark**
Since inception***	6.5%	1.2%
Six months to 31 December 2019	2.1%	-0.1%
One year to 31 December 2019	7.1%	12.0%

*Rozendal Worldwide Flexible Prescient Qualified Investor Hedge Fund. Returns shown for the B unit class, which is the earliest unit class in existence. Return numbers for other unit classes may differ slightly. Returns shown assume income is reinvested gross of tax.

**FTSE/JSE All Share Total Return Index

***1 February 2018

A. Introduction

This letter again deals mainly with developments in the Rozendal Worldwide Flexible Prescient Qualified Investor Hedge Fund ('the QIHF' or 'the fund'). In future, we will expand commentary to include the Rozendal Global Fund ('the Global Fund'), as the Global Fund was finally signed off and launched in December – to our great delight. More on this later in the letter.

B. Investment Returns

Fund returns have been modest over the past year. In relative terms returns lagged the benchmark. The global tech sell-off of late 2018 dragged Naspers – and thus the FTSE/JSE All Share index – down with it. But there was a strong rebound in the first half of 2019. We have very limited exposure to global technology companies in the fund. Hence the fund outperformed in 2018 but underperformed in 2019. Naspers is a top ten holding in the fund, but this is the long leg of the Naspers stub, and thus the Naspers holding is offset by a similarly sized short position in Tencent.

Notable positive contributors to returns over the past year have been the following:

i. Platinum mining shares

We have previously touched on the strong positive contribution the fund's holdings of Anglo American Platinum and Impala Platinum delivered over the past two years. We have had a longstanding (and painfully held) view that platinum was priced too low, and that the large, lower cost platinum miners in South Africa should deliver attractive economics to shareholders through a cycle. Accordingly, funds managed by us have been invested in platinum mining shares for several years now (i.e. even since before inception of the Rozendal QIHF). The latter half of 2018 eventually proved to be the bottom of a crushing downcycle in the platinum industry, as the result of a lack of investment in South African production capacity coupled with continued solid demand for platinum group metals ('PGM's') have filtered through into the market price of the metals.

It has been fascinating to witness the change in sentiment and views towards the PGM metals. Stories of how recycling will destroy the market for mined PGM's, and how the market faces surplus production for years to come, were common before 2018. Currently, recycling barely features as a point of discussion in a conversation around PGM's, and industry consultants forecast deficits for all the metals until the mid-2020's.

While the platinum price itself has continued to languish at relatively modest levels, the prices of palladium and rhodium (part of the PGM basket, and also used in automotive catalysts) have exploded. The charts below give some context to the quantum of these price moves (note the different time scales – there is more data available for platinum than for palladium and rhodium).

Figure 1: Platinum price percentage deviation from logarithmic trend



Figure 2: Palladium price percentage deviation from logarithmic trend

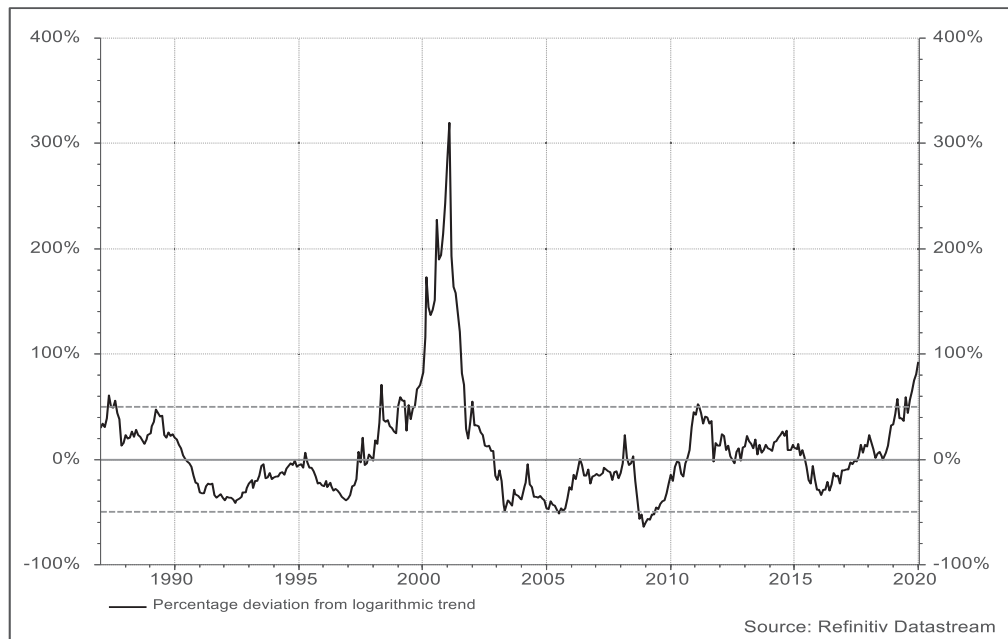
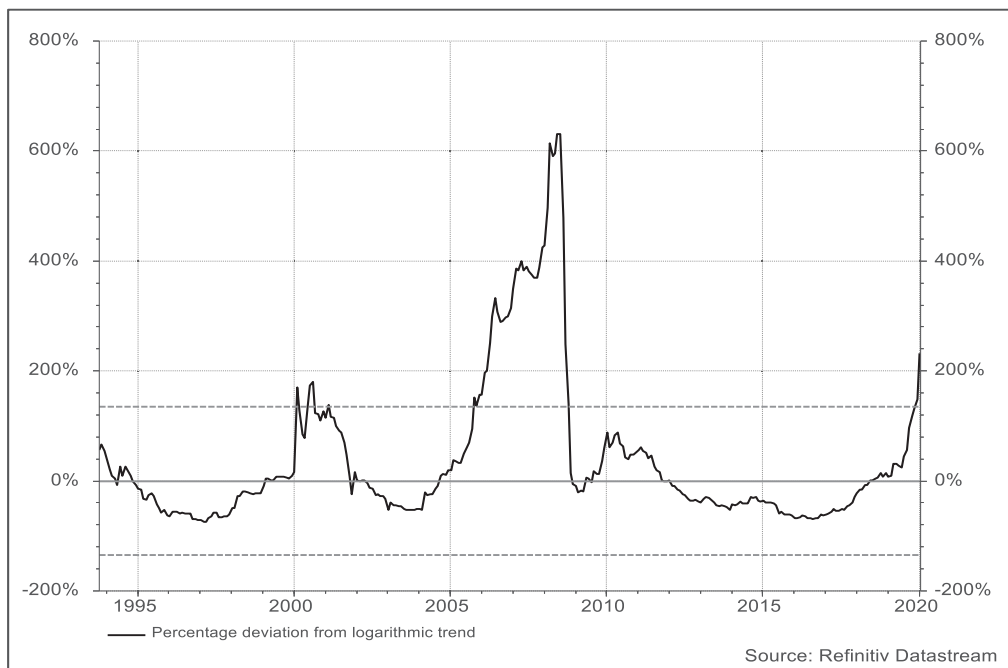


Figure 3: Rhodium price percentage deviation from logarithmic trend



Given prevailing PGM prices and exchange rates, the South African platinum miners will be making phenomenal profits. The risk of going out of business faced by some of them at the bottom of the cycle is something long forgotten, and as this risk has evaporated, so share prices have climbed.

The fund currently still holds platinum shares, but given developments in the sector, we are monitoring these holdings carefully. While there has been little sign yet of over-exuberant capital expenditure, we have seen the first signs of ‘optimism induced’ deal-making with Impala agreeing to acquire North American Palladium for a punchy price per reserve ounce of PGM metals. This is to be distinguished from the opportunistic, bottom of the cycle acquisitions that Sibanye-Stillwater engaged in during the pre-2018 period. Further acquisition activity of the optimism-induced kind, and capital expenditure on new projects, are signs we are watching for as indicators of the cycle heading to high levels, where investor caution is warranted.

ii. Grand Parade Investments

Grand Parade has again been a positive contributor to returns. While it has been far from a steady path, we are by and large pleased with developments at the company since we became more actively involved in pushing for governance improvements at the group. We were somewhat disappointed with the price at which the company was recently willing to sell one of its crown jewels – a 30% interest in the Sun Slots limited pay-out machine business – to majority shareholder Sun International. But at least the larger problems in the group – loss-making businesses with no real prospect of ever generating decent returns, and governance – have been addressed. The share price has started to reflect these improvements.

iii. Reinet Investments

Many investment holding companies talk the talk of unlocking value. Few follow through. Reinet has been a notable exception to this rule. There can be few better ways for the management of a discounted holding company to unlock – and generate – value for shareholders than through share buy backs. The problem with share buy backs from a management point of view is that it shrinks the corporate empire – which is typically at odds with the natural inclination and incentives of management teams. This is even more relevant where management earn a fee based on the size of the company – as is the case with Reinet.

We took note of Reinet’s announcement that it will be buying back shares quite aggressively during 2019 with equal measures of surprise and joy. Clearly the controlling Rupert family’s ownership interest in Reinet – and the value they can add to it by buying back shares – outweighed their interest in earning management fees from Reinet. Combined with a solid recovery in the share price of large underlying investment British American Tobacco, Reinet delivered very strong investment returns during 2019.

On the negative side, the following featured prominently:

i. Naspers stub

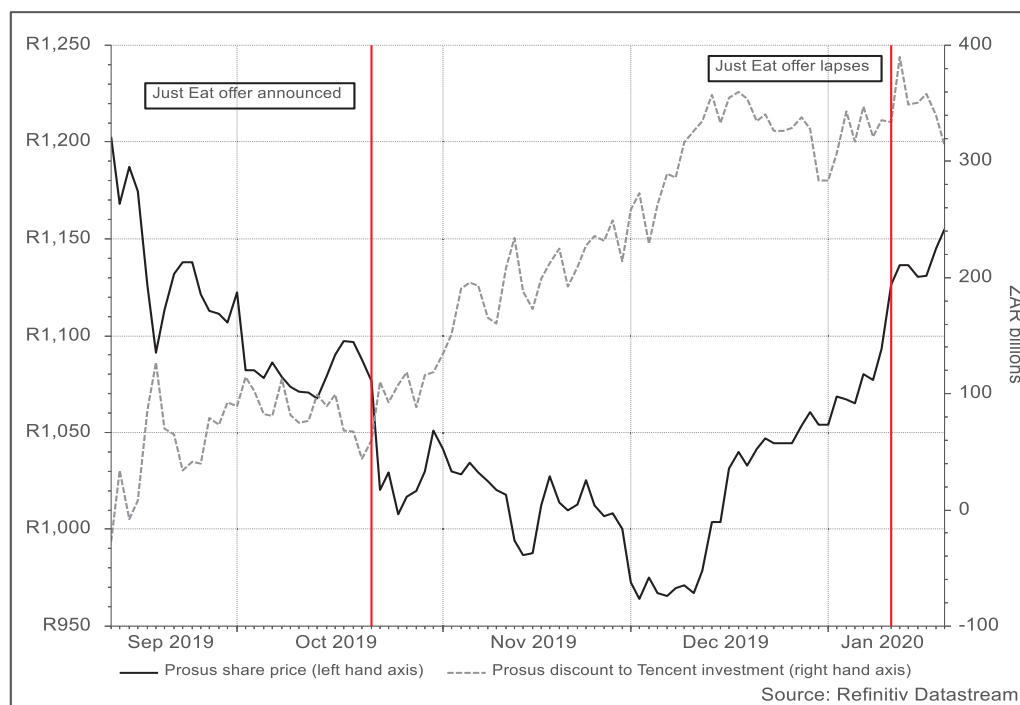
For most of the time during which the fund has been invested in the Naspers stub, developments have been positive for unlocking the vast discount embedded in the structure. Selling Tencent shares and

unbundling Multichoice were clear steps in the right direction. The creation of Prosus was supposed to be a further step in this direction.

In a rather complicated unbundling process, Prosus became a 74% held subsidiary of Naspers, holding all the group's non-South African assets. These constitute the overwhelming majority of the value in the Naspers group. Media24 and Takealot.com are the only South African assets in the group, and are of trifling value compared to the international investments. Prosus was listed in Amsterdam to attract more global institutional capital into the share – capital that may historically have shied away from investing on an emerging market bourse like the JSE. This constraint has often been cited as one of the reasons why Naspers has traded at such a discount to its underlying investments.

In the first days post listing in September, Prosus did trade at a very narrow discount to the sum of its (mainly listed) investments. This discount steadily grew, albeit to only modest levels, in the ensuing weeks. However, Prosus then announced a hostile take-over offer for Just Eat plc. Just Eat is a global food delivery business, with leading market shares in the U.K., Canada, Europe and Brazil. At the time of Prosus' offer, Just Eat was already the subject of another (friendly) take-over bid from Takeaway.com. Food delivery is a very 'hot' market currently, with several global businesses (listed and private) attempting to build large scale marketplaces in the industry. Substantial capital is being pumped into the industry. We tend to view acquisitions in such circumstances with a pretty jaundiced eye. And the market appeared to do so too: the stock sold off sharply on the day of the announcement, and Prosus' discount to its investments started creeping up from there.

Figure 4: Prosus share price and discount to Tencent investment



This divergent share price performance of Prosus (and Naspers) compared to Tencent hurt returns for the fund. Fortunately, Just Eat's board and shareholders persisted with favouring the Takeaway.com offer, so Prosus' offer lapsed unsuccessfully shortly after the end of December. And in a very favourable development as we were writing this letter, Naspers announced that it would be selling a small percentage of its Prosus shares and using the proceeds to buy back Naspers shares. Given the greater discount that Naspers trades at to its underlying assets than Prosus, this is exactly the type of value accretive capital allocation that we would like to see more of. And if we do indeed see more of this, the Naspers stub should prove to be a very satisfactory investment.

ii. MTN

The hits just keep coming for MTN. Just as prospects appeared to be improving in Nigeria – contributing to a pleasing share price performance in the first half of 2019 – a new set of challenges arose.

Firstly, tensions in Iran – an important market for MTN – continue to escalate. While MTN's Iranian business managed to operate very successfully under a regime of sanctions from the West until the 2015 nuclear agreement, the 2018 withdrawal of the US from the Iranian nuclear accord and re-imposition of sanctions is a clear negative for the country. It has amongst other things resulted in a sharply weaker exchange rate. Harsher sanctions from the West – including Europe – and continuing military conflict in the country is a clear risk to the prospects of MTN in Iran.

Secondly, in a controversial ruling, the competition authorities in South Africa took a dim view of the price of mobile data in South Africa, and effectively ordered the mobile network operators to decrease data prices substantially or face prosecution. This stance by the authorities is not likely to go unchallenged by the network operators on various grounds, but it certainly presents an operational headwind.

And then most recently, MTN has been accused of effectively financing terrorist organisations in Afghanistan by paying protection money to such groups to 'safeguard' their assets in the country. This is very much a case of 'damned if you do, damned if you don't', but in the short term it has contributed to negativity towards the share.

Issues like these are to some extent part and parcel of doing business in emerging and frontier markets, and one cannot expect to be unaffected by politics if one does business in such jurisdictions. Investing in the likes of MTN means signing up for these risks. When risk becomes reality it is never pleasant, and this has unfortunately obscured the performance of a management team which has been doing a good job otherwise.

iii. Stefanutti Stocks ('StefStocks')

Because we sold out in full from StefStocks in the past six months, we cover this investment in more detail below.

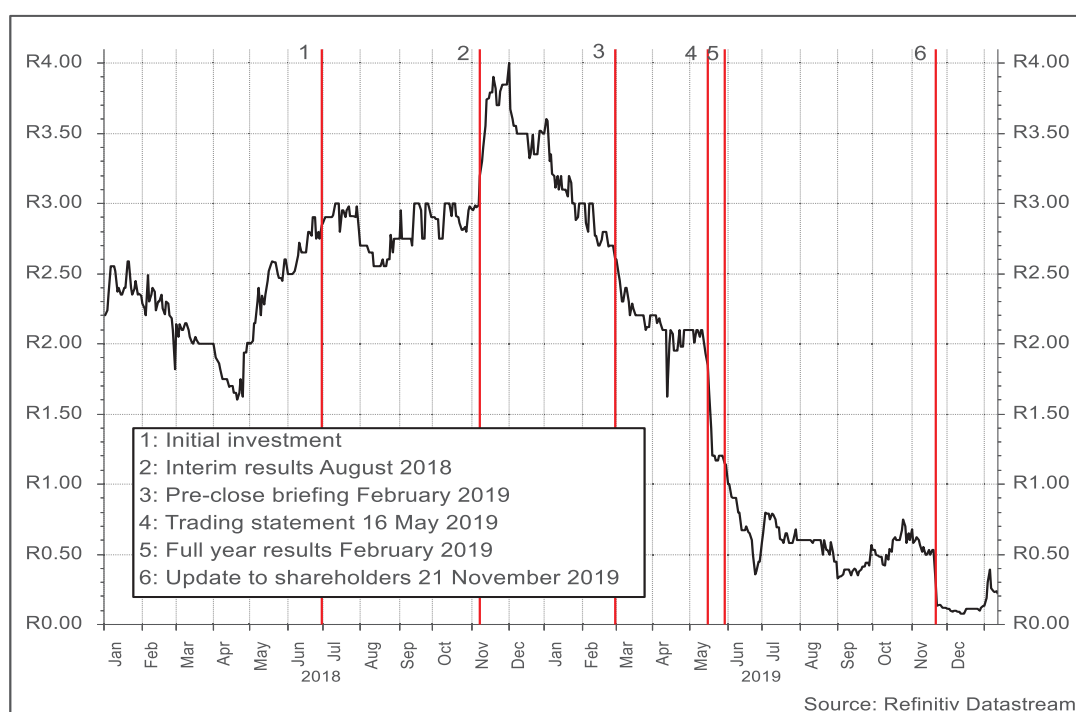
B. Investment Cycles Completed: StefStocks

We 'inherited' some StefStocks shares in the fund upon launch and invested in a more considered way in StefStocks shortly after the fund launched. At the peak, StefStocks represented a 2% holding in the

fund. It was part of a diverse number of small cap, South African-focused and fairly illiquid shares owned in the fund – all with the one common characteristic of being exceptionally cheap. Given the nature of these holdings, we would be hard-pressed to ever make any one of them a large holding in the fund.

We divested in full from StefStocks shortly before the end of 2019. This represented a fairly short (18 months odd) holding period. The brevity of the holding period unfortunately made the painfulness thereof particularly salient, despite the modest size of the position. Here follows the post-mortem.

Figure 5: StefStocks share price history and corporate developments



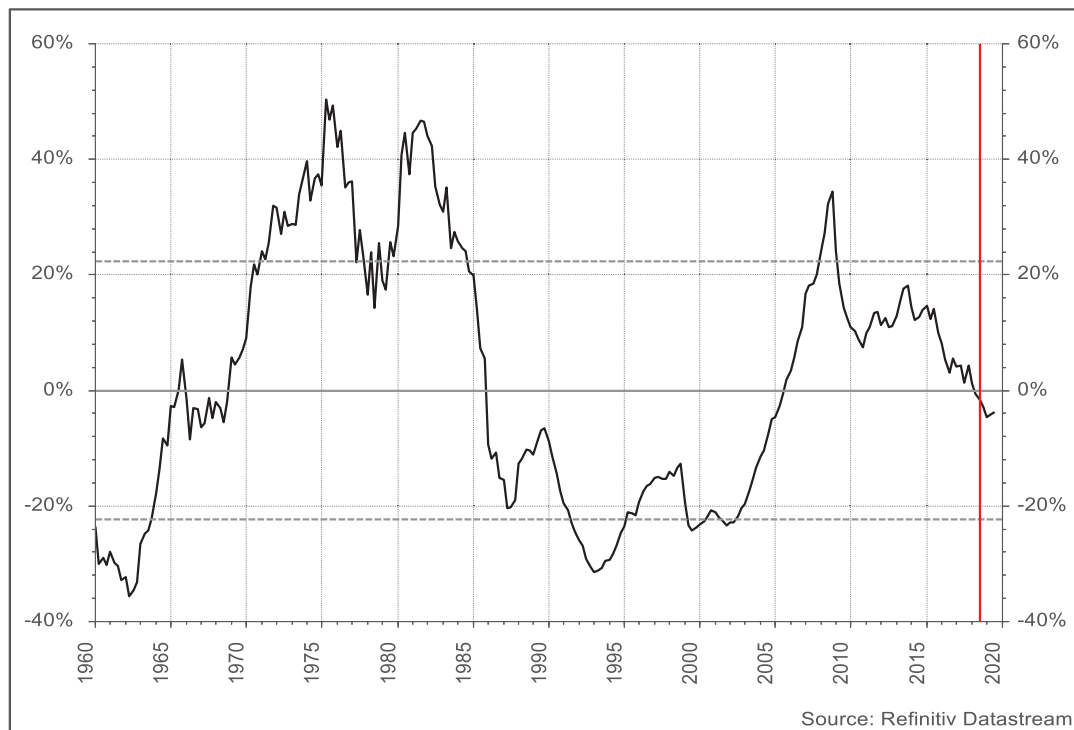
StefStocks was founded in 1971 and has a long history in the South African construction industry. The company listed and raised cash opportunely in 2007 during the South African construction sector listings boom. But then, in typical post initial public offering fashion, the cash was spent on acquisitions. By far the largest of these was Stocks Limited, a South African construction industry peer that also had an established presence in the Middle East. To be fair, two thirds of the Stocks acquisition price was paid for with very highly rated StefStocks shares – which is of course the right thing to do when one's equity is expensive (as StefStocks' was at the time). In aggregate, StefStocks spent R1.7bn on acquisitions from 2007 to 2012, which added R151m to profit after tax. This low double-digit price earnings multiple was premised on the acquired assets growing profits. Instead, profits evaporated as the industry cycle deteriorated – making the acquisitions expensive mistakes, in hindsight.

When we invested in StefStocks, we had been following the company for many years. The challenges of the South African construction industry were already well documented at the time. Excess capacity created in the boom years leading up to the 2010 Soccer World Cup had created a compulsion to take

on uneconomic work to delay the inevitable downsizing that was required. The way in which revenue is recognised in the construction industry has historically created substantial scope for judgement to be involved in reporting profits. This, combined with the long duration nature of many construction projects, create the opportunity for companies to kick the can of a lack of profitable business reasonably far down the road. But as with all can-kicking exercises, it can lead to nasty surprises come the time when contracts come to completion and the cash must be tallied. And so it was in South African construction in the mid to late 2010's.

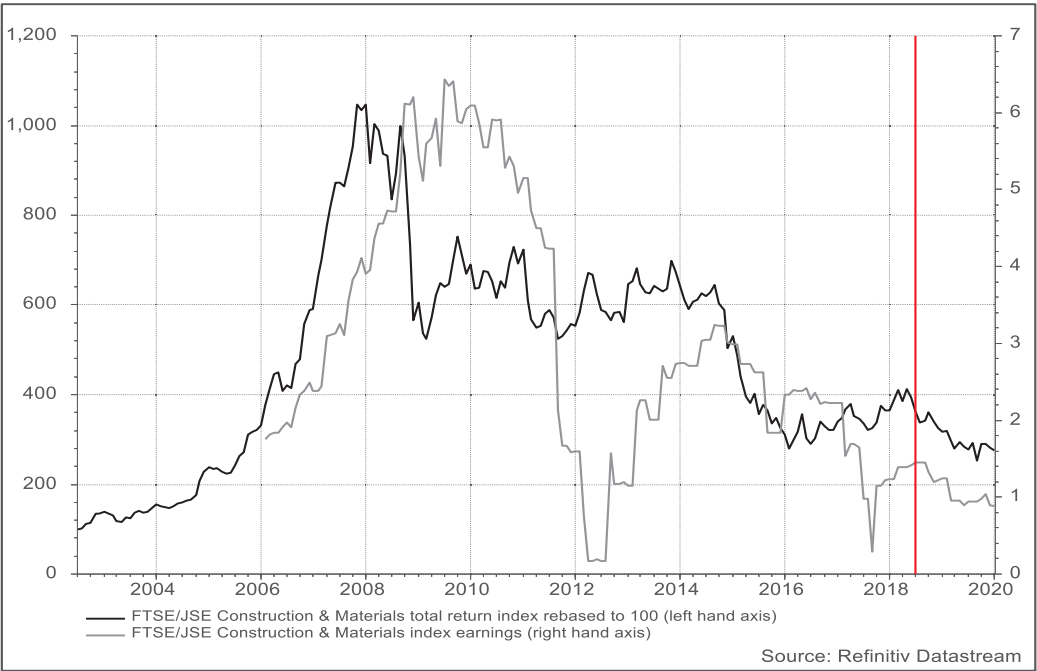
Figure 6 below shows how sharply gross fixed capital formation had retreated from the 2008 highs by the late 2010's (on all the charts below, the first red vertical line indicates where we initially invested in StefStocks – corresponding to the date of the initial investment in Figure 5 above).

Figure 6: South Africa Gross Fixed Capital Formation percentage deviation from logarithmic trend



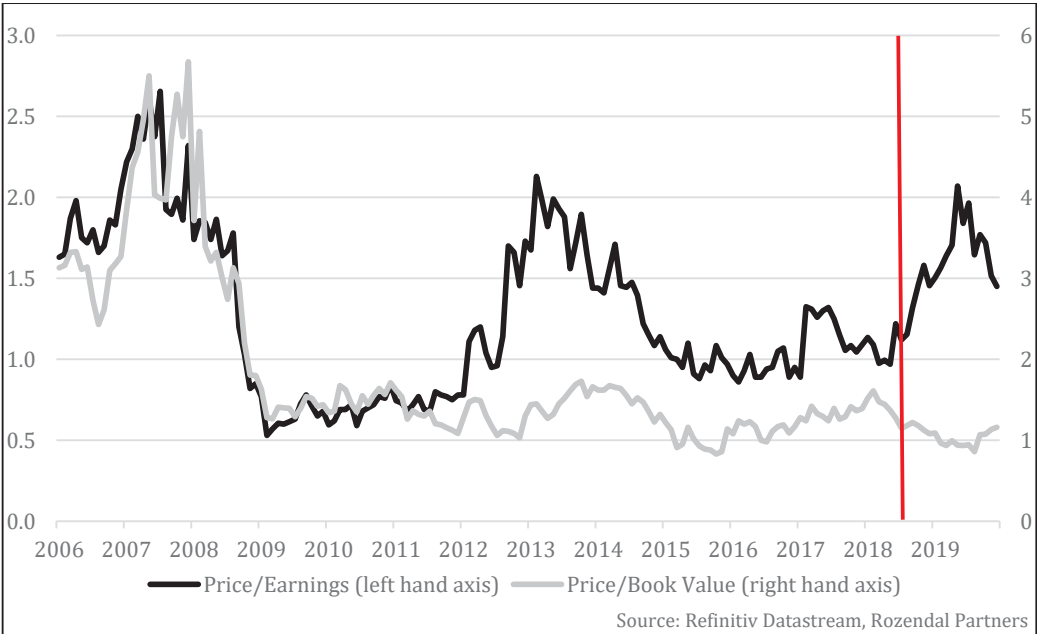
Not surprisingly, the earnings and stock prices of JSE listed construction companies had followed suit.

Figure 7: FTSE/JSE Construction & Materials index and earnings



Price earnings and price to book valuation multiples (which we only have available for the index since 2006) had developed as follows:

Figure 8: FTSE/JSE Construction & Materials index price to earnings and price to book value



The share price of StefStocks had followed broadly the same trajectory as the overall index, but by early 2018 it had reached all-time lows on more stable measures of value like price to book value and enterprise value to sales. By this stage there was blood on the streets in the construction industry. Of the five largest listed construction businesses in South Africa (WBHO, Murray and Roberts, Aveng, Group Five and Basil Read), only WBHO appeared to be in any shape fit to survive the downturn:

- Murray and Roberts had given up on the construction industry in South Africa and sold its South African construction business to a black empowerment group.
- Aveng had been forced into an emergency rights offer to stay afloat, but it was looking increasingly likely that even the rights issue would not save it.
- Group Five was scaling down its construction business, selling off manufacturing assets and was increasingly reliant on its Investments and Concessions business as a source of group value.
- Basil Read had entered business rescue.

This appeared to be classic bottom of the cycle conditions, with weaker players leaving an industry where survivors would prosper when the cycle turned. In such an environment, there are often numerous optically cheap assets – many of which turn out to be value traps. While the highest risk assets (i.e. most at risk of failing at the bottom of the cycle) will deliver the highest returns if the cycle turns quickly, we tend to lean towards the safer ‘easier’ options of the better quality assets where one may not make as much money when the cycle turns, but where the probability of making it through the cycle is better. The safe investment in the industry was clearly WBHO. But a (relatively) expensive share price and concern about cyclical conditions in Australia (a material part of WBHO’s business) dampened our enthusiasm for the company’s shares. StefStocks had a number of characteristics that made it appealing to us as an investment:

- The company was widely respected by peers in the industry as good contractors, unlikely to find themselves on the wrong end of a large loss-making contract, the likes of which had sunk (or was in the process of sinking) Basil Read, Aveng and Group Five. Diligence and discipline in contracting has historically been the defining difference between the strong (WBHO) and the weak (most of the rest of the listed industry) in the construction industry.
- Management owned 15% of the company, with the CEO owning 9% of the business personally. This was a uniquely large stake compared to others in the industry.
- While the company had somewhat more debt than what management considered ideal, it was a far cry from the situation at Aveng, Group Five and Basil Read. A notable contributor to this debt situation was a large fine issued to StefStocks by the Competition Commission on account of collusion in tendering for projects related to the 2010 Soccer World Cup.
- Operating profit margins were at record lows. In our valuation, we conservatively assumed that these margins last forever, and applied a modest multiple (6 x EV/EBIT) to our assessment of through the cycle normal earnings. Even on this seemingly conservative basis, fair value appeared to be almost twice the prevailing share price.
- Within the South African construction industry, government projects were of great concern. The financial stress and mismanagement of many state-owned enterprises had resulted in many instances of late payments and/or disputes with construction companies, pushing some

into business rescue and bankruptcy. StefStocks' exposure to public sector work was modest, at 19% of their SA order book.

- StefStocks had solidly profitable businesses in the Middle East and in the mining industry, where business conditions and prospects were distinctly more positive than in the core South African construction segment.

The first set of results the company reported after our investment was the interim results to August 2018. Key features from this set of results to us were:

- The order book was declining due to continued tough business conditions. No real surprise here.
- The mining division was growing on the back of new contract wins – a nice positive.
- The balance sheet was still somewhat stretched, and debtors' days were well above longer term normal levels, due to three large outstanding payments for work completed in Nigeria, Zambia and for the Department of Human Settlements in South Africa.
- There were some issues being reported around their contract for construction services for Eskom at the new Kusile power station, but it appeared that these issues were being handled and moving in the right direction.
- The company had been buying back shares at very attractive prices (in our opinion) but were scaling this down in order to strengthen the balance sheet before they would proceed with further substantial repurchases.
- There were no loss-making contracts on the books – in other words it appeared that the company had priced all existing contracts reasonably well.
- The CEO announced that he would retire during the following year and likely sell his holding in the company – which was probably the only notable negative news to surface at this time.

On balance, there were no major surprises coming from this set of results, and we maintained our fair value where it had previously been – well above the prevailing share price.

The next major investor interaction was a pre-close briefing the company held prior to going into the closed period for their February 2019 full year results. This time the message proved to be somewhat more ominous:

- Construction activity in Gauteng had virtually ground to a complete halt, straining the business.
- A coal mining client had gone into business rescue, and there were some execution problems on a project for an industrial gas client. This resulted in performance bonds being called up by the client. This had stretched the balance sheet to an uncomfortable level.
- There were ongoing struggles to recover money owed to the company in Nigeria and Zambia.
- The Kusile issues had taken a turn for the worse and it was looking like arbitration proceedings may be instituted at some point. In the meantime, StefStocks had to continue performing on the contract if they ever hoped to be paid – which meant more working capital investment had to be funded.
- Banks had become unwilling to provide any further funding to StefStocks– clearly a problem considering the Kusile situation.

- On the positive side, the business in the Middle East, and the mining business, were doing reasonably well.

These balance sheet developments prompted us to engage in some sales of StefStocks shares and build an assumption of a substantial rights issue at 50% of the prevailing share price into our fair value. This cut our fair value estimate in half. But of course, we weren't the only investors aware of the increasingly challenging circumstances for the company, and the share price had declined to levels well below our downwardly revised fair value. Hence, we maintained a holding in StefStocks, as opposed to selling out completely.

The full year results were released one day before the JSE-imposed reporting deadline – never a good sign, in our experience. But before the results release, the company issued a trading statement, which made for bleak reading and dragged down the share price sharply.

- Construction revenue had declined 23% as the Gauteng business was winding down.
- The dispute with Eskom around the Kusile project had escalated. Eskom was refusing to pay for overhead costs incurred due to project delays and increased work flowing out of the project. It appeared increasingly likely that there would be a major struggle to get paid for the work done. But to have any prospect of getting paid at all, the company would have to continue performing under the contract, placing further pressure on the balance sheet.
- The company had resorted to some innovative funding mechanisms with an insurance company to tide over cash flows and was also investigating the sale of half the South African construction business to avoid a rights issue.
- On the bright side, the Middle Eastern business had made more profit in the year than the South African construction business had made in the preceding 12 years. But this was not sustainable, as a large, profitable contract had come to conclusion during the year.

The fact that we were now assuming a rights issue in our fair value made our fair value a hostage of the market price of the shares: the price at which any new shares are issued – and hence the extent of the dilution suffered by existing shareholders – is a function of the prevailing market price of the shares. For valuation-based investors whose stock in trade is the notion of evaluating the fair value of assets with no regard for market noise, this is clearly not an ideal situation. We maintained our holding due to the depressed share price, but our lack of conviction was probably apparent in the fact that we weren't adding to the investment – and neither were company directors buying shares.

In the months following the full year results, the company communicated progress on a funding plan to shareholders, but the Kusile dispute escalated further, intensifying the funding pressure on the group. Matters came to a sharp head in late November, with the company issuing a dire trading statement.

- The Kusile disputes had developed such that the company would be declaring a very large loss for the period to August 2019.
- A restructuring plan was being implemented involving the sale of assets, internal restructuring, and the possibility of raising new equity.

This announcement appeared to us to show that the writing was on the wall for StefStocks. The extent of a recapitalisation required to address the company's debt levels relative to the market cap of the

company was such that existing shareholders faced mortal dilution. We decided to sell the fund's entire holding despite a share price that would have appeared ridiculously low even a few months earlier.

Lessons learned (or knowledge reinforced) from our StefStocks investment? There were a number:

- Prepayments from clients are a notable source of funding for work performed by construction companies. When the order book starts shrinking, these prepayments wind down, creating a need for cash in the business at exactly the time when investors and financiers are least likely to provide cash on favourable terms.
- Because of the prepayments, cash balances on construction company balance sheets can be misleading. One should be very careful in calculating net debt balances for construction companies based purely on reported balance sheet numbers. Look closely at net interest earned or paid during the year: this can be a better indication of the true state of the balance sheet.
- Increasing trade receivables are always a cause for concern in any business – especially so in a construction company, where one debtor can be a very material part of the overall balance.
- Over time, it seems that the South African construction companies have become increasingly reliant on a smaller number of larger projects – typically from government. This gives them less bargaining power relative to their client, and often less generous prepayments from the client to fund ongoing construction work. The working capital requirements then become unbearable for the company if a dispute arises. Where disputes arise, the clients can take advantage of the vulnerability of the construction company by dragging out resolution for many years, placing the business under further strain, and forcing them into relatively unfavourable settlements.
- The South African contract mining industry has experienced a similar worsening of contract terms to the construction industry over time, and all the listed companies in the industry went out of business in the last down cycle. We will be approaching any further investments in these sectors with even more caution than usual until such time as there are signs of contracting terms improving.
- We should perhaps have read more into CEO Willie Meyburgh's actions. Pushing through with retirement amid such epic business challenges, and never buying shares in the face of an ostensibly very cheap share price, should perhaps have alerted us to the true extent of the problems facing the company.
- In the face of severe distress in a low barrier to entry, low margin industry, listed companies can easily find themselves at a disadvantage to smaller, unlisted companies. For one, the costs associated with being listed and complying with all the related governance requirements (much of which are fixed in nature) places small listed companies at a structural cost

disadvantage relative to private competitors. At times this can make the difference between surviving or perishing.

- The dramatic rate of decline from the peak of the South African construction industry cycle in the 2008 – 2010 period was perhaps too vivid in our minds compared to where the overall level of fixed capital expenditure was in South Africa at the time of our investment. Refer to Figure 6: while the pace of decline from the peak to 2018 levels was sharp, the level of fixed capital investment was (and is still not) particularly low relative to long term trends. But it is probably also worth noting that the historical peaks and troughs of the cycle have been so far apart (30 years peak-to-peak and trough-to-trough), and lasted so long, that it is an open question as to whether an assessment of the fixed capital cycle in South Africa actually constitutes investable information.
- When a distressed rights issue looms on the horizon, fair value becomes a fluid concept dependent on the whims of the market. One should probably interrogate the integrity of a fair value estimate under such circumstances with increased vigour and recognise the ephemeral nature thereof even more so than usual.

C. Investment observations

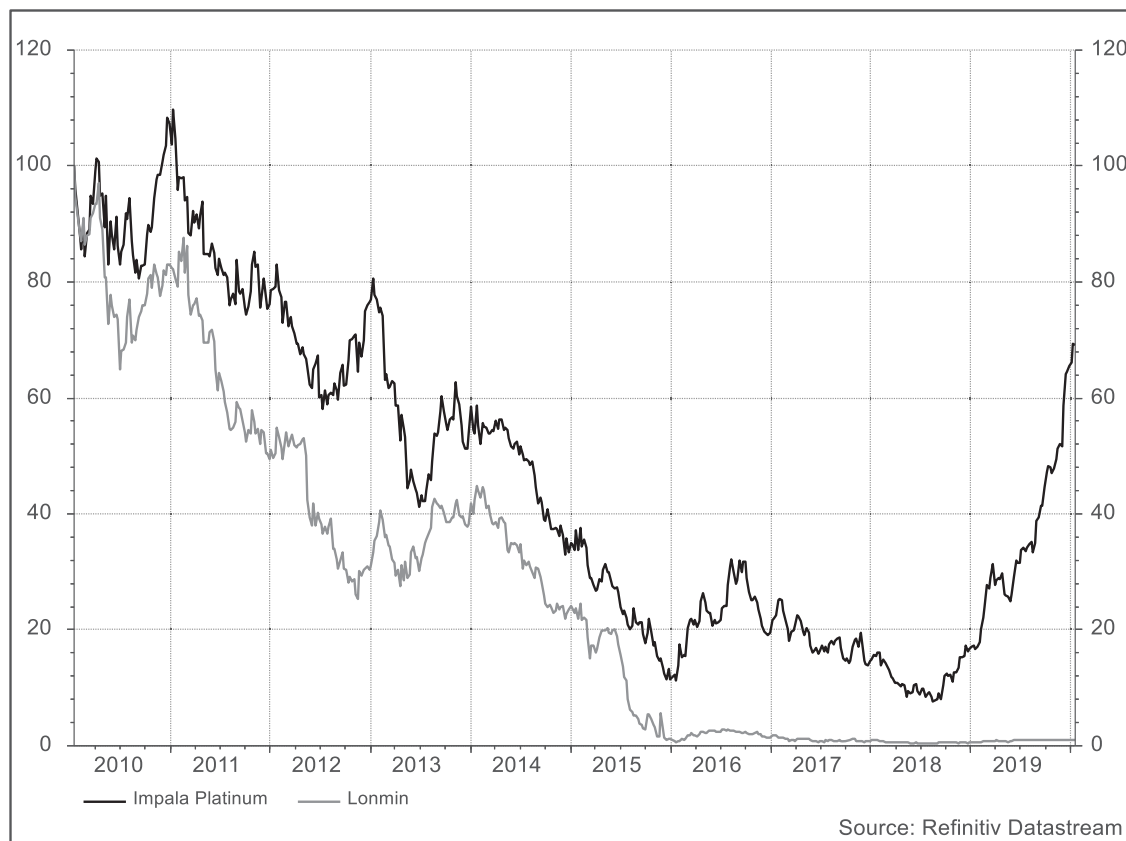
Our experience with StefStocks once again highlighted the eternal tension between remaining disciplined in the face of challenges to one's investment thesis and view of fair value, and being flexible enough to recognise that facts and circumstances have changed in such a material way as to justify a change in one's investment decisions. We try to remain open minded and objective in such situations, but it will always be a test of judgement.

In theory it sounds easy: when the facts change, change your mind – to paraphrase John Maynard Keynes. In practice, it is of course far more challenging. One inevitably faces two questions:

1. What do the new facts suggest about the future cash flows that the asset will generate?
2. And to what extent are these facts already embedded in the price of the asset?

We have often in the past been faced with these questions when investing in distressed industries where business conditions keep deteriorating. Inevitably, share prices react at least partially in tandem with business developments, so the stock looks perpetually 'cheap' as the industry deteriorates. Separating the survivors from the stragglers can be challenging. The platinum industry provided a case in point: at the very bottom of the cycle, Impala Platinum found itself in a not too dissimilar situation to Lonmin not long before. Yet Impala's self-help actions allowed it to first survive, and then prosper. In contrast, Lonmin shareholders were bought out by 'white knight' Sibanye for a pittance.

Figure 9: Impala Platinum and Lonmin 10-year share price histories (rebased to 100)



In these situations, an analyst's judgement is put to some tough tests. Capitulation can be tempting – and is sometimes the right course of action. Admirable discipline can easily morph into costly obstinance. Managing that balance will increasingly be the defining task of fundamental investors applying judgement in an investing landscape that is becoming ever more quantitative.

D. Rozendal Partners update

We were thrilled to receive news that the Rozendal Global Fund was finally approved in full by all relevant regulatory authorities during December. The fund is US dollar denominated and open for investment – either directly into the fund, or via the South African feeder fund. We apply the same investment philosophy and process in the Global Fund that we do in the South African hedge fund. But it is a long only fund, so there will be fewer unconventional investments in the Global Fund than in the South African hedge fund.

To date, we have been investing directly in global stocks in the QIHF. As far as we believe that it makes sense for a South African fund to own global assets (and we expect that this will be the case most of the time – though to varying degrees), we will be investing in these assets via the Global Fund. We do of course ensure that there is no 'double-dipping' on fees in the process.



If you are interested to hear more about the Global Fund, do not hesitate to get in touch with any of us for more information or assistance.

Yours sincerely,

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Wilhelm

A handwritten signature in black ink, appearing to read "Paul", is written over a horizontal line.

Paul

A handwritten signature in black ink, appearing to read "Jan", is written over a horizontal line.

Jan

23 January 2020