February 2021

Annual letter to investors

"… It's true we'll make a better day, just you and me." We are the World, Michael Jackson

The last 12 months required bravery

You were brave with us. You trusted us even when markets were on the steepest decline in history. Thank you.

What matters most is people

The past year has shown each of us what's really important. The common denominator among our team is that people matter most. The people we love, the people we laugh with, the people we trust and the people to whom our hearts reach out. As your asset manager, we would usually write to you about your money. This year, we believe it is more appropriate to write about people. Granate is its people. The companies and institutions we invest your money in are *their* people. And the market is all the people we invest alongside. We have decided not to quote a single performance number in our letter this year as we remember that life is not about numbers, but about people.

We have realised that making good investment decisions is not about being ahead of breaking news or understanding virology. It is about listening to each other and helping each other. The Granateam spent endless hours talking – about work, and about life. We built and broke investment cases. We retested, revisited and rethought how our portfolios are made up. We also laughed and cried together, held virtual book clubs and ran our own online exercise classes. We were people together. This was good for us and, we believe, good for our clients. We were physically apart, but we pulled together to execute on our one thing: a relentless commitment to protect and grow your savings.

But enough about us. Let's talk about the remarkable people involved at the companies and institutions where we invest your money.

Locally, our top holdings include well-known retailers, banks and industrial companies

SA banks

The local banking sector proved resilient in the face of COVID-19. The South African Reserve Bank (SARB), led by Governor Lesetja Kganyago, responded decisively as the crisis hit. Over the course of the year, it cut interest rates to historic lows and bought government bonds in the secondary market (i.e. bonds other investors were selling) to the value of roughly R30 billion. These measures gave relief to everyday South Africans by making credit more affordable, while also buffering the bond market against withdrawals by investors who had grown fearful. In addition, the SARB's Prudential Authority, headed by Deputy Governor Kuben Naidoo and responsible for regulating banks, lowered capital reserve requirements and recommended that banks not pay dividends. He was able to do so as our banks had been required to build well overcapitalised balance sheets over the prior decade to prepare for a situation just like this. Building up the artillery is one thing; being able to pull the trigger at the right time is another. Our SARB nailed both. Relaxing reserve requirements while holding back dividends meant that banks could continue to build equity buffers while also lending out more, freeing up money for use in the economy. To our mind, the SARB did an excellent job to steady the ship and stimulate the economy.

Our fixed income funds lend to almost all the major South African banks, and we therefore consider the robustness of the local banking system as well as each bank's balance sheet. Nedbank and Capitec are two examples. Nedbank is a large equity and fixed income holding in our funds. Mike Brown, its CEO, has proven to be an incredibly safe pair of hands. Under his watch, the bank has achieved responsible growth: it has steadily expanded its client base while keeping both operational costs and bad debt in check.

In contrast, Capitec (a significant equity holding) was launched in 2001 to shake up the status quo. Co-founders Riaan Stassen and Michiel le Roux saw a gap in the market to make banking simple, accessible and affordable. Capitec's strength has been its focus: for many years, it resisted the temptations of additional sources of revenue and offered only a single account: a combined transactional and savings account. Today, it is South Africa's largest bank by number of clients. Having established itself, it has since expanded its product offering.

At the height of the COVID-19 crisis, both banks set aside additional provisions for potential bad debts but are now finding that credit losses were not as bad as anticipated. This may mean that they resume dividend payments sooner than expected, as the Prudential Authority has recently relaxed its recommendation to withhold these (although it is still encouraging prudence).

Mr Price

Laurie Chiappini and Stewart Cohen met working on shop floors. Having realised the potential for the format, they opened the first Mr Price as a factory store in 1987, converting the premises of an old biscuit warehouse in Durban. The shift from factory shop to value fashion followed in the early 1990s, allowing Mr Price to carve a unique niche in the South African market. But what's ultimately made this business great is its focus on its people.

Mr Price is protective of what it stands for, making sure that management share the same vision through strong succession planning and a history of leaders earning their stripes. One of the most unique parts of the Mr Price story is that the two co-founders were Co-CEOs for a decade. Upon appointing a successor, they became Co-Chairs of the Board for a further 13 years – and then Co-Honourary Chairs. (Cohen continues to serve in this capacity, with Chiappini having retired in 2015 at the age of 70.)

Sharing the top spot like this is rare, but it is testimony to a culture that is not about any one person; just about Mr Price. Aside from the co-founders, the company has had only three CEOs, with the first two retiring after total tenures with the company of well over two decades. (The current CEO, appointed in 2019, has been with Mr Price since 2006.) On a broader level, all permanent employees qualify to receive Mr Price shares and share options as long-term performance bonuses. This makes them co-owners with a vested interest in the company's success.

It's the people at Mr Price that have ensured that the business stays true to its principles as a cash-based, value fashion retailer. This has allowed it to anticipate and meet the changing needs of its customers – the people it serves. It's what drove its expansion into sports- and homeware, its strong online presence, and what lies behind more recent launches like a make-up line and a baby clothing range. It's also what's driven double-digit compound annual growth in earnings per share over more than three decades – and why we believe the iconic red cap will remain a comfortable fit for many years to come.

Italtile

Italtile was founded in 1969 by Giovanni Ravazzotti, an immigrant from Italy. He saw a gap in the market for affordable tiles and ceramic products as South Africa became increasingly urbanised, so he started to import them. Realising the threat of sanctions against the country in the late 1970s, he also set up a local manufacturer, Ceramic Industries. Today, Italtile is the industry cost leader, as it manufactures over two thirds of its own products and owns several of the quarries that supply its raw materials. It also owns (without excessive debt) the sites of its retail stores, saving on lease payments while earning rental income from franchisees.

With four retail brands (including Italtile and CTM) that cater to clients across the price spectrum, Ravazzotti – who still serves as non-executive Chairman – has proven himself an astute entrepreneur. The current executives continue to build on this legacy, with Italtile recently reporting double-digit growth in key financial metrics (such as group-wide turnover and profit) for its half-year to end December 2020, bouncing back strongly from trading lost due to COVID-related lockdowns. There is strong alignment across the business, with the Ravazzotti family still owning most of Italtile through a holding company, and other employees taking part in both a share scheme and profit share.

Afrimat

Afrimat is involved in the open-pit mining, processing and supply of materials and minerals, mostly to the construction industry. Since its launch in 2006, founding CEO Andries van Heerden has transformed Afrimat from a materials business with a few quarries to a resilient, diversified operator. While a slowdown in government spending has caused South Africa's construction sector to struggle in recent years, Afrimat's management team has proactively sought opportunities to broaden its offering. The secret to the team's success has been staying within their circle of competence: buying cheap, under-performing assets with the potential for a turnaround under the guidance of Afrimat's experienced people. The Demaneng iron ore mine, which Afrimat bought in 2016, is a great example. It has allowed Afrimat to capitalise on surging iron ore prices and to generate strong cash flows even during the height of the Coronavirus pandemic.

Importantly, we have found the people at Afrimat to be positive at times when many others were negative. This is not coincidental, as Afrimat invests in its culture and seeks out like-minded people. Moving forwards while others were moving backwards has positioned the company well to take advantage of local growth opportunities in infrastructure investment and mining.

Retail Capital

As a successful entrepreneur with a passion for start-ups, Karl Westvig co-founded Retail Capital, one of our fixed income exposures, in 2011. His vision was to boost small South African businesses by helping them achieve their own success. Retail Capital spearheaded a 'Merchant Cash Advance' financing model, which advances funding to small and medium enterprises against the money they're due to receive from credit card purchases. The innovative funding model, strong client relationships and personalised repayment arrangements have all led to strong growth, very low losses and an exciting future for the business.

Westvig and his leadership team are passionate and dynamic, and have real skin in the game through share ownership. As a result, the culture of the business is remarkable. This was never clearer than in 2020, when COVID-19 lockdowns had dire impacts on the businesses Retail Capital funds. The company continued to disburse funding, listened to their clients' needs and were supportive in finding workable repayment solutions.

Investors and stakeholders received a book detailing journeys of struggle and survival to overcome lockdown – including many of hope and success. In the book, Westvig writes: "As a business we have a culture of innovation and give people the opportunity and freedom to make a difference." He also notes that 'it all comes down to the quality of the people you surround yourself with'. We couldn't agree more.

Government bonds

An investment in government bonds requires faith in both the monetary and fiscal authorities. In South Africa, this means the SARB and national government (specifically, the National Treasury). We hold the SARB in high regard. It has an excellent track record of managing inflation, ensuring a stable banking system and stimulating the economy when needed and appropriate. Our national government has a more chequered track record.

The two most important requirements for South Africa to turn the fiscal corner are trust and growth. We believe that the presidency and National Treasury have regained a baseline of confidence by demonstrating that government's first priority is the people, rather than the pockets of officials. But we also desperately need growth. This is why it was so positive that our government didn't freeze when it suddenly faced a double-digit fiscal deficit. It came out guns blazing in favour of growth, and indicated how it will allocate to achieve this. It also showed hard evidence of infrastructure investments, which are pivotal for an economic recovery. We certainly saw some of the freedom fighter spirit in our leadership during March and April.

These measures, combined with the steps taken by the SARB and the strength of our banking system, provided comfort that we are going to get through COVID-19 in reasonable shape. When the coronavirus crisis and various other economic forces wreaked havoc on fixed income markets over the year, we were positioned with cash on hand to invest. As the prices of South African government bonds fell, their yields (interest rates) rose to compensate for higher perceived investment risk. So, we bought. This was nerve-racking, as panic was widespread and yields continued to climb. But we stuck to our conviction and supported each other through some very tough markets. The bonds have since performed well for our clients, and the crisis has reminded us again how valuable it is to be flexible, liquid and nimble. It allowed us to offer liquidity to a panic-stricken market – the conditions under which the best deals are done.

Our top global holdings include several semiconductor businesses and Twitter

Semiconductors: Lam Research, Micron and Taiwan Semiconductor Manufacturing

Before we introduce you to the people involved at these companies, here's a bit about the things they make. Semiconductors, also known as chips, are the microscopic components that are packed together to form integrated circuits. They are the building blocks of every piece of electronic equipment you own. As our world becomes ever more digitised and connected, the need to generate, transmit, store and process data grows exponentially. In addition to computers, tablets and mobile phones, consider cloud computing, wearable devices, artificial intelligence, autonomous vehicles, the internet of things, and… well, the list goes on.

Semiconductors are manufactured using a complex process of cleaning, depositing and etching extremely thin layers of material on silicon wafers that are fractions of a millimetre in size. The process is mind-bogglingly complex. This means that even though demand is exploding, there are only a few experts in each area. We have exposure to three semiconductor companies, all part of oligopolies in unique parts of the industry. We back these experts for different reasons.

Lam Research (Lam)

Lam supplies the highly specialised equipment that semiconductor manufacturers use to make memory and microchips, the 'picks and shovels' of the industry. After years of consolidation, the equipment market now has only two or three major players in each category. Lam is the leader in etch, and second in deposition (the largest and most important segments). Lam's executives hold PhDs in mechanical engineering, electrical engineering, material science and physical chemistry. Most importantly though, they carry decades of institutional memory that cannot be replicated. In this industry, technology evolves. Lam will be working on technology today that won't come into commercial production for many years. It might never come into commercial production. The important part, however, is that you must be entrenched in the evolutionary process to even have a chance of being part of future solutions.

Taiwan Semiconductor Manufacturing Company (TSMC)

Founded in 1987 by the visionary Morris Chang, TSMC is an independent contract manufacturer, producing microchips for the world's top product designers and equipment manufacturers. Three quarters of the 23-member management team has been with the company for more than 20 years, and a few ex-founders and managers continue to provide their expertise as board members. With Intel falling years behind, TSMC and Samsung are now the only companies in the world producing logic chips with the most advanced specifications. The secret to TSMC's success is that management has never strayed from the strategy to enable, rather than compete with, TSMC's clients. This has allowed collaborative innovation and win-wins. Through economies of scale and operational excellence, TSMC can get maximum bang for every buck management invests in the business, making for very attractive economics. Considering that it produces over half of the world's chips, TSMC is probably the most important company in the world right now. We trust management to keep it that way.

Micron

Micron is one of three memory chip producers who together supply 90% of the market. Memory chips are more of a commodity. However, the industry has consolidated, sources of demand are growing, and it is becoming increasingly costly and complex to scale as chips evolve. As a result, there is evidence of higher barriers to entry, improving supply/demand dynamics and more stable growth. Micron is a cost-efficient producer at the forefront of innovation in the two primary computer memory types. It has been led since 2017 by Sanjay Mehrotra, who co-founded Sandisk and has more than 70 patents to his name. With the memory cycle only just starting to turn from its recent low, we believe its competitive positioning and strong leadership team make Micron an attractive opportunity.

Twitter

Jack Dorsey is hailed as a visionary tech entrepreneur, having co-founded two multi-billion start-ups: social media platform Twitter and mobile payment company Square, both of which he continues to run. An interesting and unconventional character (he is also a qualified masseur, studied botanical illustration and completed a course in fashion design), he is credited with creating cohesive corporate cultures that encourage strong buy-in. In 2017, for example, he gave up Twitter stock worth over $200 million so that it could be shared among employees as part of the company's incentive plan. He also earns an annual salary of just $1.40 from the company (one US cent for each of the 140 characters Twitter initially allowed per message), tying his fortunes to those of the business through stock ownership instead.

While Dorsey has historically been criticised for the slow pace of development at Twitter, he has emphasised that this was intentional. His focus was first on ensuring the health of the platform (making it a safer and more constructive forum) and on 'getting the basics right'. Having now established this base, Twitter has already started to gain traction, performing strongly over the year. We believe there's more to come as Twitter leverages the platform to grown profitable revenue streams.

Thank you for sticking with us

Calling ourselves an asset manager is accurate, but it doesn't capture the essence or soul of our business. We may manage assets, but in truth we are determining a portion of people's lives. We are managing the rewards of your hard work. We are accountable for helping you achieve what you're investing towards. This is a huge responsibility. In this letter, we have tried to show that we are sharing it with many committed and capable people across many different organisations in many different parts of the world. Our responsibility is therefore ultimately to pick the right people, and this is an important part of our analysis process.

Serving you is a privilege for which we are sincerely grateful, and we look forward to looking after your money through whatever may lie ahead – the good, and the bad.

Sincerely
The Granateam

"If an egg is broken by an outside force, life ends. If broken by an inside force, life begins. Great things always begin from the inside." Jim Kwik