

April 2020

## DESERT LION CAPITAL FUND I, LP Q1 REPORT FOR THE PERIOD ENDED MARCH 31<sup>ST</sup>, 2020

Dear partners and friends,

This letter will be of most interest to those readers who are inclined to buy when there's blood in the street. When the cycle of fear and greed reaches extremes, sentiment becomes systemic, and correlations tend towards 1.

We've seen a massive global sell-off across all asset classes so far in 2020. The South African market was already trading at cheap valuations, which have proceeded to drop even further. Many days, and in several companies, I witness prices violently dislodged from the fundamentals. This is the type of set-up sage investors referred to when they said the market is a mechanism for transferring wealth from the emotional to the rational, from the impatient to the patient.

No one knows where the market will bottom, but we know we are buying robust companies at dirt cheap valuations. The best time to buy is when you don't want to buy. We hope you will consider joining us in buying wisely during this multi-year (and probably multi-decade) opportunity.

To highlight this opportunity, Desert Lion is accelerating the closing of our Founders Class. Investors who participate in our May 1<sup>st</sup> and June 1<sup>st</sup> closings should expect to pay zero (0%) management fee; the class will close thereafter.<sup>1</sup> Here is that rare window of opportunity to both "get in" to the South African market at what we believe is an incredible entry point and also lock in a compelling fee structure.

### Founders Class is closing – time to raise capital and deploy wisely

Ours is not a tame market; one must be strapped in with steady temperament to endure the volatility. To grow our wealth, we believe that a concentrated portfolio of well-selected positions can outperform an index by focusing on a few great ideas over a long time horizon. I have been managing outside capital in South African equities since 2013. During that time our same strategy predecessor funds outperformed the JSE All Share Index<sup>2</sup> 10% per year on an annualized basis. I know all about bumpy rides, and I'm happy to accept intermediate volatility in the pursuit of outsized returns.

The best time to deploy capital is usually when it feels like the worst time to deploy capital. In previous letters I wrote that our opportunity set was attractive on an uncertainty- and risk-

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<sup>1</sup> The Founders' class will close after June 1<sup>st</sup> or when it receives an additional \$8 million in subscriptions, whichever occurs first.

<sup>2</sup> FTSE/JSE All Share Index ("ALSH" or "J203") converted to USD returns.

adjusted basis.<sup>3</sup> Since then, risk and uncertainty have increased, and the market has re-rated our portfolio holdings downwards. In my opinion, the extent of the additional discount exceeded the increase in risk and uncertainty. I am convinced that our current opportunity set is more attractive than ever before on an uncertainty- and risk-adjusted basis.

My job is to invest in good businesses at attractive prices and avoid stupid decisions. I am seeing good businesses trading at valuations I have never before witnessed in my investing career.<sup>4</sup> Now is a prime time to raise capital and deploy that capital wisely.

We will close the Founders Class to new investment after the June 1<sup>st</sup> subscription date or when it receives USD 8 million in new subscriptions, whichever comes first.

The Founders Class pays zero management fees. Below are the salient terms:

	Founders Class	Standard Class
Management fee	0%	0.75%
Performance fee	25% of profits exceeding hurdle	25% of profits exceeding hurdle
Hurdle rate	6% hard, non-compounding	6% hard, non-compounding
High water mark	Yes	Yes
Fund expenses	Capped at 0.5%	Capped at 0.5%
Soft lockup	2 years	3 years
Early withdrawal fee	5%	5%
Min subscription	\$250,000	\$250,000
Capacity	June 1 <sup>st</sup> or \$8m, whichever first	Intend to close at \$100m

We are currently accepting subscriptions for May 1<sup>st</sup> and June 1<sup>st</sup>. If you are interested, please get in touch with Ally Manning at [InvestorRelations@desertlioncapital.com](mailto:InvestorRelations@desertlioncapital.com) or me at [rudi@desertlioncapital.com](mailto:rudi@desertlioncapital.com). We are at your disposal to provide additional information and answer any questions you might have. I am also happy to take calls to discuss the fund and our approach. Please remember that the fund can only accept accredited investors and that our minimum subscription is \$250,000 for everyone except for those of you who are existing LPs wishing to add to your investment.

## World class companies at SA discounts

Following are a few examples of what we own and/or are buying currently...

<sup>3</sup> I view risk as the probability of permanent loss of capital, or stated otherwise, the probability of bad outcomes. We try to identify possible bad outcomes and then assign a probability to that outcome. In the process we want a probability weighted outcome that minimizes the probability of permanent loss of capital. One of the ways of reducing risk is by not overpaying. Another way is to buy businesses with staying power, i.e. robust balance sheets and growing positive cash flows. Uncertainty, well, is just that. The events that are unlikely to be identified *a priori*, events that are way out at the thin ends of the tails of the distribution.

<sup>4</sup> Admittedly, my investing career is limited. But the statement is legitimized when one considers that SA veterans with 25-years plus investment experience comment that they are seeing dislocations in the SA equity markets they have never witnessed before in their own careers.

Keep in mind that while the South African equity market sold down with the rest of the global markets, its valuations entered this pandemic at an already depressed base. South African equities weren't trading at the formerly lofty valuations of the U.S. markets. For us, the cheap have become even cheaper. We recently hosted a group of investors and capital allocators from France, Spain, Russia, Dubai, the U.K./Monaco, and the U.S. on our South Africa investment trip. The feedback was unanimous – we are buying world class companies with world class management teams at South African discounts.

## Balwin Properties

- Base case expected return: 56% CAGR over 4 years.
- Stock price year to date: -28%.

Balwin is the largest listed residential build-to-sell developer in SA, building apartment complexes targeted at the growing middle-income class. Their target market has a current housing backlog of 700 000 units. Balwin is currently adding about 2 750 units per year, with an annual capacity of 5 000. Importantly, their brand has become known and respected in the country for its well-managed quality offerings. As a “cherry on top,” they also have the exclusive domestic rights to the Crystal Lagoons concept, which serves as a major differentiating advantage where they have been installed. Balwin recently launched Munyaka, their biggest development to date, and pre-sold the equivalent of 25% of their annual revenue in just the first 4 days. I invite you to watch the [launch event video](#), which includes an in-person address from SA President Cyril Ramaphosa.

Insider ownership is ~45%. The company is trading at 3 times after tax profits and less than 50% price-to-book.

Here is my base case back-of-the-envelope expected return calculation:

(All amounts in ZAR)	2020	2021	2022	2023	2024
Units sold	2 700	2 500	2 500	3 000	4 000
Earnings per share	0,90	0,79	0,93	1,27	1,91
Dividends (after withholding tax)		0,13	0,15	0,20	
PE multiple (entry/exit)	2,91				7,50
Fund cash flow	- 2,62	0,13	0,15	0,20	14,30
<b>4 year compound return</b>	<b>56%</b>				



*Picture: Desert Lion group briefed by Balwin CEO Steve Brookes.*



*Picture: Site visit – Balwin’s The Blyde with Crystal Lagoon.*

## Stadio

- Base case expected return: 40% CAGR over 6 years.
- Stock price year to date: -42%.

Stadio is a disruptive insurgent in the for-profit Private Higher Education (college/university) sector of South Africa. One of the big opportunities in South Africa is for the private sector to capitalize on government’s failures. SA’s public universities are full and there is a huge and growing backlog to be filled. Stadio is rapidly consolidating existing private higher education brands under its umbrella, accrediting new programs, establishing three new campuses, and integrating state-of-the art distance learning technology. The company also benefits from the stellar reputation of the primary school offering, Curro schools, founded by the same brilliant educators.

Stadio is managed by intelligent fanatic founders and has solid backing in PSG Group as 44% anchor shareholder. They have exceeded all targets since listing 2017 and have set a minimum target of 56 000 students and R 500 million profit after tax by 2026. I believe these targets are very conservative as the demand is just way too high and they will already have capacity for 100 000 students by then, operating on a 20% contact / 80% distance learning split.

Earnings are understated as the business is ramping up and they are progressing through the J-curve. The balance sheet is virtually debt-free.

Here is my base case back-of-the-envelope expected return calculation:

(All amounts in ZAR)	04/01/20	04/01/26
Students	31 869	56 000
Earnings per share	0,11	0,61
Return on Equity	6%	16%
PE multiple (entry/exit)	11	15
Fund cash flow	- 1,20	9,17
<b>6 year compound return</b>	<b>40%</b>	



*Picture: Listening to Stadio founder Chris van der Merwe at recent results presentation in Cape Town.*

## Cartrack

- Base case expected return: Minimum 20% CAGR for at least 5 years (excluding any re-rating).
- Stock price year to date: -17%.

Cartrack is a Stolen Vehicle Recovery (SVR) and Fleet Telematics SaaS business run by a superb management team. They operate in a very large and growing global market that is still relatively under-penetrated. Cartrack has industry-leading metrics (28% ROA, 47% ROE, 96% recurring revenue, 50% EBITDA margins, LTV/CAC of >6). Debt is minimal. Insider



ownership is ~80%. The company operates in “a few winners will dominate” markets where the economics are characterized by a virtuous cycle of strengthening the best products and companies: more data leads to better products, which in turn attract more users, who generate more data that further improves the product. That combination of data and cash also attracts top talent to the top companies, widening the gap between industry leaders and laggards.<sup>5</sup> Impressively, Cartrack also keeps all data in-house and prioritizes privacy rather than selling it to other parties. Cartrack is a top 10 player globally and already has dominant positions in many of the geographies they operate in. Asia-Pacific and Europe are fast growing areas for the company and soon ex-SA revenue should surpass 50% of total revenue. For a deeper analysis of Cartrack, please refer our 2019 Q3 letter.

Cartrack is trading at 3 times price-to-sales and 14 PE multiple, which is extremely cheap for a global SaaS company of this quality. The business can continue to reinvest earnings at very high returns on capital and margins will likely expand in the future as the business scales. As base case, I can see a long runway of compounding at 20% to 30% for many years.



*Picture: Desert Lion group meeting with Cartrack management.*

## PSG Group

- Base case expected return: 31% CAGR over 4 years.
- PSG stock price year to date: -45%.
- Capitec Bank stock price year to date: -40%.

PSG is an investment holding company consisting of underlying businesses that operate across a range of South African industries including banking (Capitec), financial services (PSG

<sup>5</sup> For a fascinating analysis of technology and winner-take-all markets I suggest reading “[AI Superpowers](#)” by Kai-Fu Lee.

Konsult), for-profit education (Curro and Stadio), food and agribusiness (Zeder), and earlier-stage investments in select growth sectors such as energy (Energy Partners) and lifestyle retirement villages (Evergreen). The group is run by a highly entrepreneurial management team with a stellar capital allocation track record. For a deep dive analysis of PSG and its holdings, see our 2019 Q4 letter.

Capitec is South Africa's fastest growing bank and is not dependent on short-term economic growth to grow and increase profitability. For the most recent fiscal year, banking competitors reported earnings growth between -5% and +5%. Capitec is posting 20% growth in EPS. The bank is growing market share profitably because they are delivering a better and simpler service at a lower cost to the customer. They can do this because they entered the market as a disruptive insurgent with lower cost structures, better technology, enhanced data gathering leading to more and better data, and advanced data analytics. The market is huge, with immense scope for additional product offering and cross selling across a massive distribution platform.

Capitec has the strongest banking brand in South Africa and third strongest in the world, out of 500 banks rated globally. New clients are joining at a rate of more than 200 000 per month. Capitec's banking app has been voted best banking app in South Africa.

PSG is trading at a -37% discount to its SOTP and -9% discount to its holding in Capitec alone. We are effectively buying Capitec at a 15 PE (28% ROE and growing EPS at >20% annually) and getting all the other holdings (PSG Konsult, Curro, Stadio, Zeder, Energy Partners, Evergreen, etc.) for free. Further, the group has almost no debt.

PSG is slated to receive ~R1,7bn, about 6% of their market cap from a special dividend declared by Zeder as it distributes proceeds from the recent sale of its Pioneer Foods holding. I expect a share buyback plus buying more of existing businesses trading at discounts (e.g. Stadio and Curro) to balance the portfolio and enhance intrinsic value per share.

Here is my base case back-of-the-envelope expected return calculation:

(All amounts in ZAR)	2020	2021	2022	2023	2024
SOTP (growing at 20%)	204,44	245,33	294,39	353,27	423,93
Discount to SOTP	-37%				-10%
Look-through EPS	12,60	15,12	18,14	21,77	26,12
Stock price	129,81				381,53
PE multiple (entry/exit)	10,3				14,6
Fund cash flow	- 129,81	-	-	-	381,53
<b>4 year compound return</b>	<b>31%</b>				



*Picture: Desert Lion group meeting with PSG Group CEO Piet Mouton.*

## Alviva

- Base case expected return: 81% CAGR over 3 years.
- Stock price year to date: -64%.

Alviva is a diversified ICT (Information and Communications Technology) business with three main clusters: distribution, services and solutions, and financial services.

The company is expecting short-term reduction in earnings due to several reasons, all of them transient, namely: disruption due to implementation of new ERP system, M&A at one of their major vendors, and product availability from China due to COVID-19.

Alviva has conservative debt (17% debt to equity) and is highly cash generative. They are reducing debt further by redeeming higher yield preference shares and repurchasing shares on the cheap. There is pent-up demand for Alviva's IT products and services in South Africa. Any normalization of the cycle will see a massive rebound in earnings.

Here is my base case back-of-the-envelope expected return calculation:

(All amounts in ZAR)	2019	2020	2021	2022	2023
Core EPS	3,50	2,60	2,60	3,12	3,74
Dividends (after withholding tax)			0,22	0,27	0,32
Stock price	17,44	5,30			29,95
PE multiple (entry/exit)	5,0	2,0			8,0
Fund cash flow		- 5,30	0,22	0,27	30,27
3 year compound return		81%			

The 2019 actuals and corresponding stock price one year ago emphasize just how conservative the projections are.

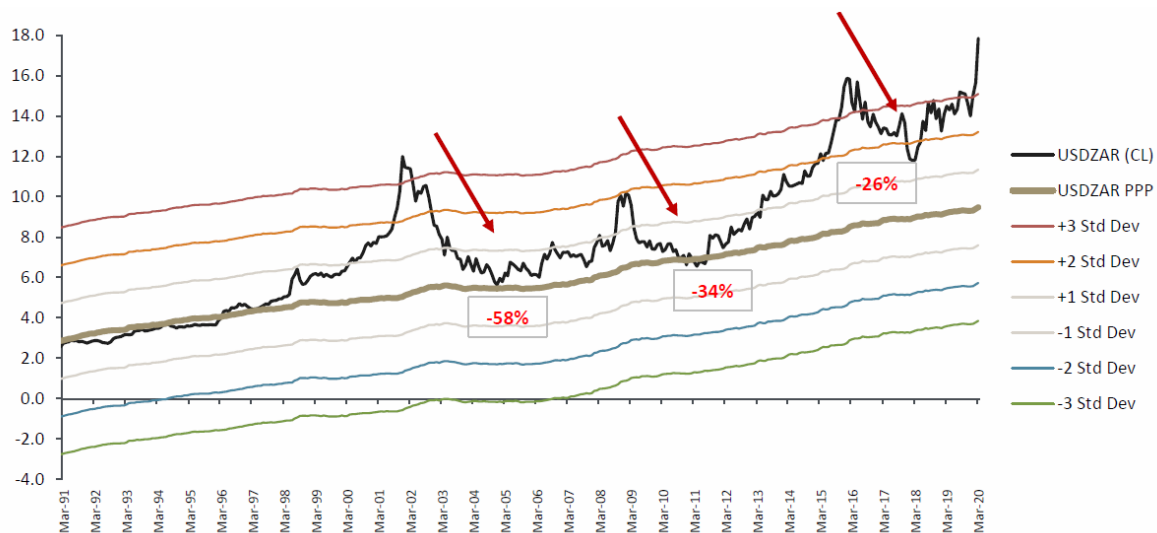


## Currency

Desert Lion's fund marked down -22% during the quarter due to ZAR/USD depreciation. It is natural to ask i) what impact can we expect in the future, and ii) what is the fund's approach to dealing with currency volatility?

We do not hedge the currency in any way. Over the long-term, the ZAR should depreciate against the USD at a rate approximating the inflation rate differential between South Africa and the U.S., i.e. about 4% to 5% per year. If the Fund wants to deliver 15% in USD, we have to generate about 20% in ZAR. I believe our opportunity set allows us to do that, and more.

Where will the currency go from here? Nobody knows. But we do have a robust model to refer to. In the short run, the ZAR/USD exchange rate displays significant volatility around the ZAR's Purchasing Power Parity (PPP). In the long run there is a very strong relationship between the two.<sup>6</sup>



*Source: PSG Wealth*

In relation to PPP, the ZAR is currently the most undervalued against the USD in at least 30 years. I am not saying that the currency will strengthen. I have no idea what it will do. But we do know that intrinsic purchasing power matters and we do know that we have a robust reference point. We also know that the divergence from that reference point is at a 30-year extreme. Any reversion will provide a handsome boost to returns.

## Recent South Africa investment trip

During March 2020, Desert Lion hosted a South African trip for global investors and allocators from seven very different countries. The trip allowed guests to form an objective, informed

<sup>6</sup> For the statisticians among our readers, there are several factors which can lead to variance in outcomes in calculating PPP. For one, the starting point matters. Another nuance is that the spot exchange rate has an influence on PPP as it impacts inflation. But the key takeaway remains: over the long run the relationship between the currency and PPP is very strong and it holds.

view of South Africa, and exposed them to the companies and management teams constituting our opportunity set.

Company and management interactions included on-site visits to Balwin Properties and Cartrack in Johannesburg; and PSG Group, Stadio, and HIK Abalone (a private business) in Cape Town. We also had a very informative session with one of South Africa's foremost independent political and economic analysts and commentators. JP Landman offered his fascinating perspective on the current and future economic and political landscape in South Africa. For the benefit of those not able to join us, we filmed the interaction and have made short form highlights and the full version viewable on our website.<sup>7</sup>

## In conclusion

- Risk and uncertainty are at extreme highs.
- It will probably get worse before it gets better.
- No-one knows where or when the market will bottom.
- In times of distress, markets behave less rational. Dislocations will intensify. Failures will emerge. Pockets of extreme value and opportunity will appear.
- Markets usually bottom before the situation is at its worst.
- I cannot time the market. Desert Lion is not in the game of trading short term price movements.
- Desert Lion's investment universe currently presents extreme opportunity when viewed through a fundamental and long-term lens.
- South Africa is an uncrowded emerging market. It offers the opportunity for outsized returns, but at the expense of higher volatility.
- My job is to invest in good quality companies at attractive valuations. When valuations are more attractive, I should put my foot on the gas. When valuations are less attractive, I should ease off a little. It is time to accelerate judiciously.
- This is a bidder's market. We will deploy wisely, patiently, opportunistically. We're not just throwing money at the market, we are bargain hunting.
- As a species, we are better at rationalizing past events than thinking and acting rationally in the moment. We tend to project the recent past indefinitely into the future. The best time to buy is when you don't want to buy.

The only thing we know for sure: this too, shall pass.

Any accredited investors interested in receiving further information are welcome to reach out to Ally ([InvestorRelations@desertlioncapital.com](mailto:InvestorRelations@desertlioncapital.com)) or me ([rudi@desertlioncapital.com](mailto:rudi@desertlioncapital.com)).

All the best,



**Rudi van Niekerk**

<sup>7</sup> Log in at [www.desertlioncapital.com/login/](http://www.desertlioncapital.com/login/) with your username and password and navigate to "RESOURCES > SA INVESTMENT TRIP".

## APPENDIX A: PERFORMANCE

### Q1 REPORT FOR THE PERIOD ENDED MARCH 31<sup>ST</sup>, 2020

	Desert Lion Capital Fund I <sup>(1)</sup> %	FTSE/JSE All Share Index <sup>(2)</sup> %	MSCI Emerging Markets <sup>(3)</sup> %
Q2 2019 <sup>(4)</sup>	3.1	6.0	0.6
Q3 2019	(10.8)	(12.3)	(4.3)
Q4 2019	13.9	12.7	11.8
Year 2019	4.8	4.7	7.7
Q1 2020	(41.4)	(39.0)	(23.6)
Cumulative <sup>(5)</sup>	(38.6)	(36.1)	(17.7)
Annualized <sup>(5)</sup>	(38.6)	(36.1)	(17.7)

#### **Notes:**

- (1) Desert Lion Capital Fund I, LP (“Desert Lion”) Standard Class, net of all fees. Based on an annual management fee of 0.75% (calculated quarterly in advance, charged monthly); fund expenses of 0.5% p.a. (charged monthly); 6% non-compounding hurdle; performance fee of 25% of profits exceeding the 6% hurdle; high water mark applies.
- (2) FTSE/JSE All Share Index (“ALSH” or “J203”) converted to USD returns.
- (3) MSCI Emerging Markets Index (“MXEF”). Inclusive of dividends reinvested.
- (4) Inception April 1, 2019.
- (5) Net results to a Limited Partner in the Standard Class as of April 1, 2019 inception. Individual returns will vary by class and date of investment.

#### **Disclaimer:**

PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.

The net returns presented under Quarterly and YTD Performance are net of all fees, expenses and the incentive allocation attributable to a typical fee-paying limited partner in the Fund. The returns for a limited partner who has made additional subscriptions or withdrawals may differ. The performance numbers include dividends reinvested. This communication is for informational purposes only and is unaudited. Totals may not foot due to rounding.

**APPENDIX B: PORTFOLIO OVERVIEW  
(DISCLOSED TO LIMITED PARTNERS ONLY)**



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## DISCLOSURES

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References to the MSCI Emerging Markets Index (“MXEF”) and the FTSE/JSE All Share Index (JSE alpha code “ALSH” or JSE index code “J203”) are based on published results and, although obtained from sources believed to be accurate, have not been independently verified. The MSCI Emerging Markets Index is referred to only because it represents an index typically used to gauge the general performance of the midcap and large caps in global emerging equity markets in more than two dozen emerging market countries including South Africa, China, India, Korea, Mexico, Taiwan, the United Arab Emirates and others. The returns for the MSCI Emerging Markets Index include realized and unrealized gains and losses plus reinvested dividends but do not include fees, commissions and/or markups. The FTSE/JSE All Share Index is referred to only because it represents an index typically used to gauge the general performance of the Johannesburg Stock Exchange as a whole. The returns of the FTSE/JSE All Share Index include realized and unrealized gains and losses, but do not include the reinvestment of dividends, and do not include fees, commissions and/or markups. The use of these indices is not meant to be indicative of the asset composition, volatility or strategy of the portfolio of securities held by the Fund. The Fund’s portfolio may or may not include securities which comprise the MSCI Emerging Markets Index and the FTSE/JSE All Share Index, will hold considerably fewer than the number of different securities which comprise the MSCI Emerging Markets Index and the FTSE/JSE All Share Index and engages or may engage in Fund strategies not employed by the MSCI Emerging Markets Index and the FTSE/JSE All Share Index including, without limitation, short selling and utilizing leverage. As such, an investment in the Fund should be considered riskier than an investment in the MSCI Emerging Markets Index and the FTSE/JSE All Share Index. Furthermore, indexes are unmanaged, do not incur management fees, costs, and expenses, and cannot be invested in directly.