DESERT LION
— CAPITAL —

July 2020

DESERT LION CAPITAL FUND I, LP
Q2 REPORT FOR THE PERIOD ENDED JUNE 30TH, 2020

Dear partners and friends,

Desert Lion returned 12.8% for Q2. Our investment space within the South African listed equities market has been slower to recover from the recent sell-off and did not follow the same trajectory as the extremely rapid rebound of U.S. stocks. Particularly due to the continued apathy and aversion towards SA listed small- and mid-cap stocks, we believe our portfolio of companies remains undervalued vis-a-vis their fundamentals and global peers. I expect the disparity to narrow over time. In the meantime, we are fortunate to have a very attractive opportunity set and deploy capital at high expected future returns.

The road less traveled

"Two roads diverged in a wood and I - I took the one less traveled by, and that has made all the difference."

\- Robert Frost

Common sense: *the ability to think about things in a practical way and make sensible decisions.*

Logic: *a particular mode of thinking, especially one that is reasonable and based on good judgment.*

Rational: *based on reason rather than emotions.*

I am not in the business of deliberately trying to be contrarian. But when common sense, logic, and rational thinking lead me to a view that is different from the crowd, then there is opportunity. As the late legendary investor Simon Marais once told me, "Be contrarian by all means, but at least know why you are contrarian." To generate outsized returns, be right when the crowd is wrong, and do so at scale.

I currently hold two views which seem to be contrary to the crowd's consensus. I believe:

1. The U.S. stock market is expensive.
2. The Johannesburg Stock Exchange ("JSE") warrants a closer look.

Let us take a deeper dive.

1. The U.S. stock market is expensive

Comparing the U.S. stock market with the underlying fundamentals of its companies probably presents one of the most extreme mismatches over the past 100 years.

The year 2000 saw the Dotcom crash. Many flawed businesses went bust. Irrational valuations returned to reality. Speculators and investors lost money, causing a negative wealth effect. Sentiment was pervasive and stocks around the globe dropped in harmony. But, ultimately, the fundamental economic impact was limited to certain industries and countries. The global economy was able to regain its footing as the fundamental economic building blocks were mostly still intact. Top to bottom, the S&P 500 experienced a -42% decline.

The 2008 Global Financial Crisis ("GFC") had a more severe economic impact. Without unprecedented stimulus, many financial institutions deemed "too big to fail" were at risk of failing and causing systemic financial collapse. The economic impacts were most severe in the housing market, credit market, financial institutions, and again, the negative wealth effect (which, of course, was disastrous for many families). Globally, stocks dropped as panic and negative sentiment spread and correlations tightened. Unemployment rose temporarily, a few bad actors and weak businesses went bust while others prevailed, and credit markets tightened temporarily. Still, most businesses around the world continued going about their daily activities, contributing to the economy. Top to bottom, the S&P 500 experienced a -51% decline during the GFC.

On February 19 this year, the S&P 500 hit an all-time high of 3 386. Then the market posted one of the fastest crashes in history on the back of the coronavirus fears. Around the globe, severe lockdowns were imposed with the intention of flattening the curve and preparing medical facilities for worst case scenarios. Apart from essential services and in-demand technology services and products, whole economies and almost all trade were basically shut down. The lasting effects are likely to lead to the worst fundamental economic impairment since World War II, or even the Great Depression, including the worst unemployment rate.[1] The economic impact is clearly more severe and more widespread than Dotcom or the GFC. Yet, top to bottom, the S&P 500 declined -34% through March 23rd and at date of writing the letter, the S&P is back at 3 185, only -6% from its all-time high.

I am not saying the market cannot or will not go higher. Valuation alone is not sufficient to cause prices to rise or fall.

The rapid recovery of the U.S. stock market is somewhat understandable. Congress passed trillions of dollars in fiscal programs while the Fed added trillions of dollars in monetary stimulus. Unemployment may be at historic highs, but many individuals are not yet feeling poorer thanks to direct cash payments and unemployment benefits. In the short run, all that additional money must go somewhere. With near-zero interest rates it is obvious that a lot of that money is going to find its way to the stock market.

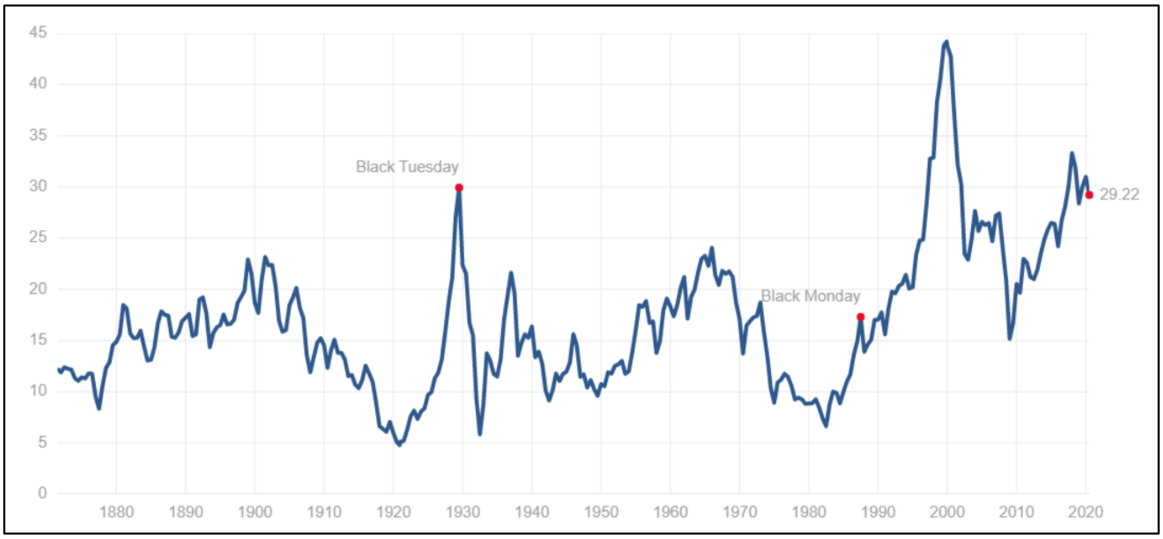
Here is the problem. The complex system driving this market higher is extremely fragile and can change rapidly, which could lead to massive drawdowns.

[1] For example, the U.S. unemployment rate peaked at 24.9% in 1933 and remained stubbornly high until 1940. The April 2020 unemployment rate was 14.7%, its highest since that time.

I make that statement within the following context:

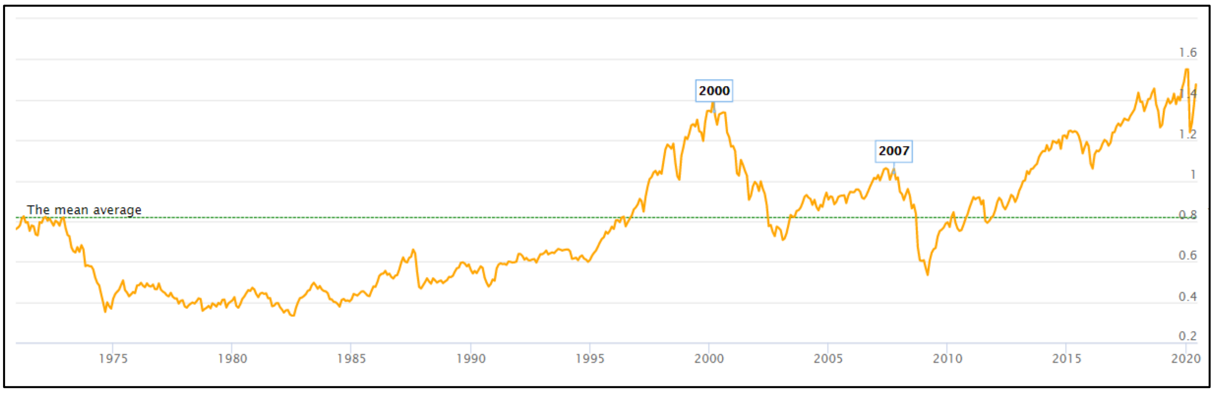
- This market is driven by an injection of liquidity, not fundamentals.
- There is a perception that the Fed will "do what it takes" and that downside is protected by the "Powell put".
- FOMO (fear of missing out) is real. It is easier than ever before for retail investors to participate in the market. Monthly gains of 30% are enough to entice most people to want to get in on a piece of the action. Similarly, it is easy to invest in low-cost index trackers, resulting in large inflows and indiscriminate stock buying.
- Loss Aversion is real. This is the flipside to FOMO. People will withdraw their money just as easily and quickly as they channeled it in the first place.
- Due to technology and social media, everything is moving faster. Sentiment changes quickly and the resultant moves are massive. June 11th is a case in point: The S&P 500 lost -6% for no apparent reason.
- The more expensive the market is relative to fundamentals, the bigger the potential readjustment to the bottom.
- We cannot predict the future, but we know unanticipated events happen. The stock market does not seem to be discounting significant unexpected negative events. Those who believe the past was without surprises are in for some surprises.

The market seems to be pricing in a best-case scenario. The CAPE ratio, or Shiller PE ratio, is near its highest levels in 100 years, only eclipsed by the highs preceding the Great Depression and Dotcom crashes. Yes, interest rates are lower, hence, discount rates are lower and multiples higher. But are current levels indicative of a market facing the worst economic impairment since World War II or the Great Depression?



Source: https://www.multpl.com/shiller-pe

The total market cap to GDP ratio is another indicator that valuations are rich, currently <u>exceeding</u> the pre-crash levels of the Dotcom and GFC eras…

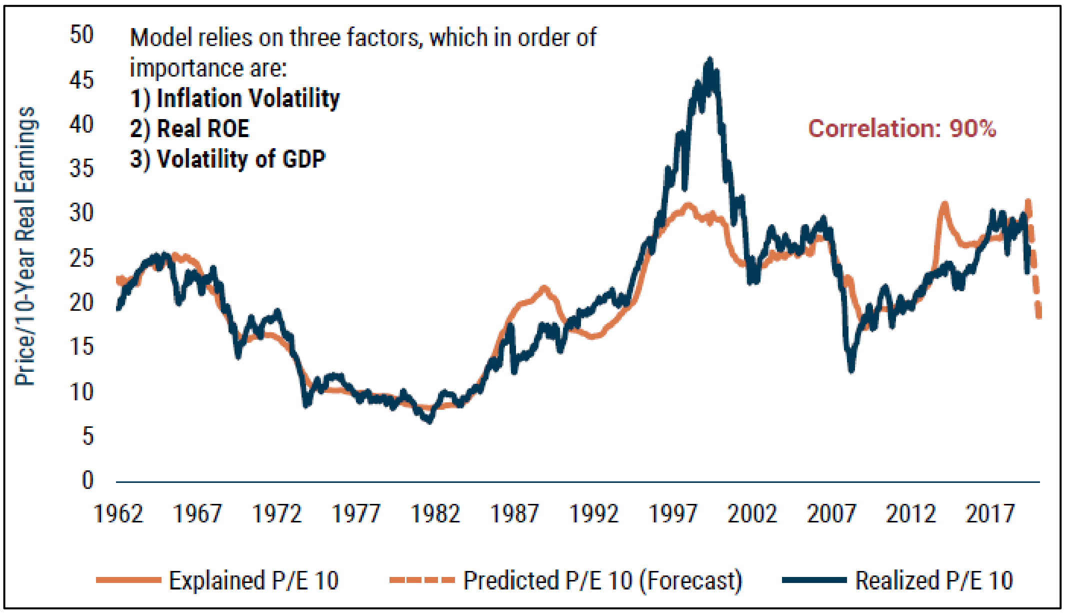


Source: https://www.longtermtrends.net/market-cap-to-gdp/

And finally, a few thoughts and a chart on the subject from the inimitable Jeremy Grantham:

"Over 20 years now, Ben Inker and I have done a lot of work on explaining price earnings multiples. Yes, the market occasionally gets impacted by panics and euphoria, but mostly it reflects the current data."

"The bet here is that for the next few quarters earnings and profit margins will be crushed and sometime during that depressed phase P/E ratios will also be pulled down as is typical, giving us a lower multiple of substantially lower earnings."



Source: https://www.gmo.com/europe/research-library/1q-2020-gmo-quarterly-letter/

In summary: I do not know what the stock market will do tomorrow, next month, or next year. The market could go higher. Common sense and logic tell me that expected returns from present levels are low and that the risk-reward profile of buying the S&P 500 at current prices is unattractive. Furthermore, the complex system driving prices is extremely fragile and any corrections will be fast and vicious.

2. The JSE warrants a closer look

South Africa is facing its fair share of challenges. The country had one of the longest and hardest lockdowns globally. There will be an economic price to pay. Unemployment reached 30%. GDP is expected to contract at least -7.2% in 2020. The budget deficit is expected to reach -15% and Gross National Debt to GDP is expected to increase from 66% to 82% in 2020/2021.

Open the news, and the headlines will shout corruption, government's failure to deliver basic services, failing state-owned enterprises, and violence.

The result? Foreign capital outflows and aversion to anything South African. No doubt, investors view SA as "icky". That said, icky is good. I like icky. Icky means less competition, higher inefficiency, more mispricing, more great businesses at cheap prices. Yes, there is a lot of worthless ore on the JSE, but the JSE can be a gold mine for the knowledgeable investor, especially in a zero-interest rate world.

Let me share an extremely valuable insight: It is a fallacy to think all JSE listed companies' fortunes will move in lockstep with SA's fortunes.

A bet on Desert Lion is not necessarily a bet on South Africa

What does it mean to have an edge? It means you do better than your competition. It means you outperform the average of the crowd you are competing against. *How* do you gain an edge? There are two ways – the hard way and the smart way. The hard way is to work harder than everybody else. The smart way is to be selective in the games you play and compete against fewer competitors. And what happens if you are willing to do both, work harder *and* smarter? Your edge will be significant.

I am not a top-down investor. I did not take a macro view and decide that SA is particularly attractive to invest in. I am a bottom-up investor. I search for overlooked or misunderstood investment opportunities that I believe can generate exceptional returns. Of course, as a bottom-up investor, I must stay within my circle of competence. Risk stems from not knowing what you are doing.

Earl Nightingale said, "Luck is when preparedness meets opportunity". As a South African investor, I cut my teeth on the JSE. Only later did I realize that there are pockets in the JSE that are very inefficient relative to other markets globally. Over the past few years, as apathy and aversion towards SA increased, the competition faded, and the degree of inefficiency just got more extreme. So here we are – at the crossroads where preparedness meets opportunity.

There are about 325 companies listed on the JSE. Many of them do not depend on the country to perform to deliver us exceptional performance. Yet, most all of them trade at cheap valuations just because they are listed in SA.

For example, Naspers is a global tech company with its largest asset a 72.4% stake in Prosus, which in turn owns 31% of Tencent. The group has significant investments in social media, payments & fintech, cloud, gaming, online classifieds, food delivery, travel, online retail, and various early stage ventures in tech. It is a fantastic combination of dominant, profitable tech businesses and evergreen startups. On a look-through basis, Naspers is trading at a -43% discount to its underlying assets. (Prosus is trading at a discount of -25% to its underlying assets, and Naspers is trading at a -23% discount to Prosus.) This is a classic example of discount upon discount, or compound mispricing. Basically 100% of Naspers' earnings and growth is global. For all practical purposes, Naspers' outlook has zero dependence on the fortunes of SA. Yet it is trading at a SA discount. We are getting an exceptional global company at a SA discount.

Global growth company Cartrack is another example. Soon, more than 50% of its earnings will be generated in Europe and Asia Pacific. Even the company's home market of South Africa is still underpenetrated; among other factors, crime and increased focus on efficiencies enhance its domestic growth outlook. Cartrack is a fast-growing global SaaS company, but because it is listed in SA, it is trading at about a -30% to -50% discount to global peers.

Argent is a small industrial company that is busy transforming its revenue base without the market noticing. Over the past few years, they have divested from SA properties and low return assets, using the proceeds to invest in higher return niche industrial businesses in the U.S. and U.K. After the completion of a recently announced acquisition in the U.K., about 60% of their earnings will be U.S. and U.K. based. However, the company is listed in SA, so it is trading at less than 35% price-to-tangible book and less than 5 times PE ratio.

Capitec is the fastest growing bank in SA. The table illustrates why Capitec is in its own league and has no comparison in any one of the country's "big four" banks.

	Capital Adequacy Ratio	Return on Equity
Standard Bank	15%	14%
Nedbank	14%	13%
Firstrand	15%	21%
ABSA	15%	12%
Capitec	**31%**	**28%**

Capitec is not dependent on South Africa's economic growth to grow its business. Instead, Capitec is growing by winning market share and expanding product ranges. How is this possible? The "big four" are large and lazy incumbents with heavy overheads and aged legacy systems. Capitec took an asset light technology approach and disrupted the market with simple, efficient, and affordable banking products. Capitec still has relatively small market share in most of their segments and will continue to grow rapidly, even in a SA zero-growth environment. We are buying Capitec through PSG at a -20% discount. Another great growth company, at a SA discount.

Labels and investing styles

Sometimes I get asked what investing style I follow, e.g. value, growth, etc. I do not think it is beneficial to try and box oneself into any of these labels. Labels might help with marketing material, but ultimately, they are flawed.

Where did these labels originate? Slicing and dicing of data and academic research revealed "factors" that on average performed different to the dataset. Low price-to-book or low price-to-earnings became "value" stocks. High price-to-book or high return-on-equity became "growth" stocks. Stocks with the best trailing twelve-month price performance became "momentum" stocks. Then of course there is the halo effect. Once Warren Buffett was branded a value investor, the term gained prominence, and seemingly everyone styled themselves as value investors.

These labels are nonsensical within our fund's context. I am not looking for value stocks or growth stocks. I have a universe. From that universe I develop an opportunity set. Each candidate in that opportunity set has a risk-adjusted[2] expected return. I call that my opportunity cost curve. We invested in the top 7 to 15 stocks from that opportunity set. From that perspective, I would say our approach is enterprising or opportunistic. The harder we dig in places where no one else is digging, the more opportunities we find to augment our opportunity set and improve our opportunity cost curve.

Logically, price plays an important role. For any given stock, all things being equal, the lower the entry price the higher the expected return.[3] The price must make sense in context of the underlying business. So, from that perspective, we are value conscious.

Above is why anyone who tries to apply labels to the holdings in our portfolio will find a mixed bag. There are so-called growth stocks (Naspers, Cartrack, Capitec), underappreciated early stage business (Stadio), cyclical value stocks (Alviva, Balwin), and businesses undergoing transformation (Argent, PSG). There is no uniform label for our portfolio of holdings. They are simply the best from our opportunity set. They all have a high expected return and as a group they are likely to outperform our investment universe.

Looking at our current portfolio, I would say there are two themes emerging.

Firstly, many of our companies can scale, and their high growth rates are tech-enabled. Cartrack is a telematics SaaS company. Capitec is a technology-driven bank benefitting from digital adoption, biometrics, and advanced machine learning in credit granting. Stadio, the for-profit university, is developing some of the most advanced online learning technology in partnership with Unit4 (www.unit4.com). Within 5 years, they aim to have capacity for 100,000 learners with a 20%/80% contact/online split. Naspers is a fully fledged technology company with the group constantly developing and investing in new tech. Curro, the for-profit schooling business, accelerated the development of their online delivery technology on the back of Covid-19 structural changes.

Secondly, where we own SA-focused companies, many were launched to grow into the void and profit from government's failure to deliver. Specifically, essential services or products in large markets with attractive supply demand mismatches. For example, Balwin, SA's largest listed residential property developer, builds affordable housing for the urban middle-income class. They currently complete about 3,000 units per year and benefit from an unaddressed demand of 700,000 units. Curro and Stadio are addressing the huge demand for private schools and universities caused by the government's public education failures. South Africans

[2] Risk-adjusted simply means I do a subjective assessment of uncertainty. I assign a degree of confidence, or probability, to the potential outcome. There are no fancy mathematical formulas. I do not consider volatility a risk factor.
[3] Even if the outcome is a loss. If the entry price is lower, the loss is smaller compared to the loss from a higher entry price.

will continue to spend on decent housing to enhance their standard of living and spend on quality education to enhance their chances of success in life.

The complementary addition to U.S. equities asset class

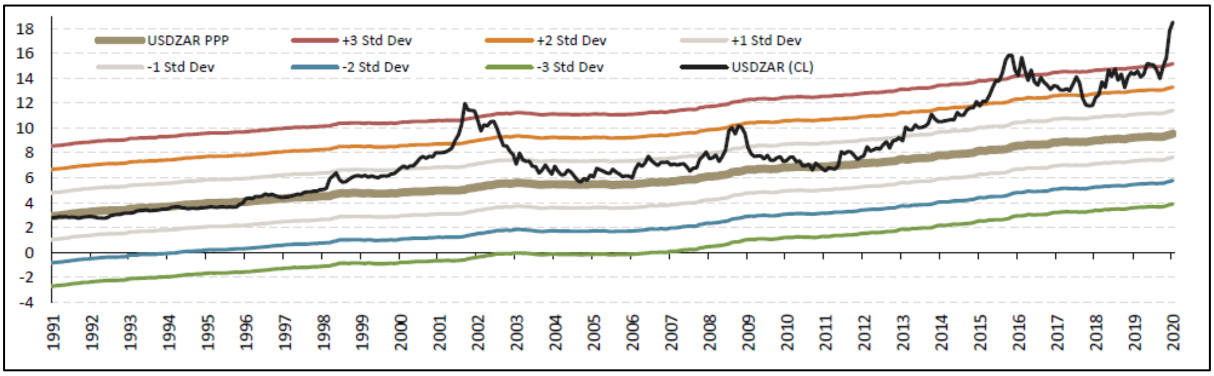
The Desert Lion Capital Fund offers a logical addition to allocators with significant exposure to U.S. equities as an asset class.

As discussed in the previous section, our portfolio as a collective comprises defensive characteristics and a diversified emerging market growth profile, at an attractive price. It follows that returns over the long run should augment U.S. equities returns, but in a less correlated fashion.

Investing in an emerging market fund means exposure to emerging market currency. Who said that can only be a bad thing? The USD had a spectacular performance over the past 10 years. As a basket, EM currencies and EM equities have underperformed the USD and U.S. equities over the past 10 years. This has not always been the case and the trend can revert.

Source: https://www.koyfin.com/research/2020/06/15/usd-to-weaken-as-fed-commits-to-qe-infinity-and-beyond/

While I cannot predict currency movements, it does seem that the USD/ZAR exchange rate is offering an attractive entry point based on its long-term relationship with Purchasing Power Parity ("PPP").



USD/ZAR Spot vs PPP. Source: PSG Wealth

Finally, how many other alternatives are available to invest in an:

- U.S. domiciled fund that…
- invests exclusively in SA listed equities,
- specializing in off the beaten path small- and mid-caps,
- managed by a South African fund manager?

The fund offers a niched and unique access point to an attractive opportunity set in a less competitive landscape, which we believe positions it as a great addition to U.S. equities as an asset class.

Portfolio update

Many of our companies reported annual results during the second quarter. I also stay in touch with many of our companies' managers to keep my finger on the pulse of our businesses. Following are some brief updates. (All amounts in ZAR).

Cartrack

Global stolen vehicle recovery and telematics SaaS business. Reported results for the fiscal year ended February 2020.

- EPS 148c, up +28%.
- 44% return on equity.
- Recurring revenue 97% of total revenue.
- Excellent cash conversion and high cash generation.
- Balance sheet practically debt free.
- Strongest growth Europe (EBITDA +45%) and Asia Pacific (EBITDA +94%).

Desert Lion outlook: fantastic business with a long runway.

Balwin Properties

Largest listed residential property developer in SA, focusing on sectional title housing for urban middle-income class. Reported results for the fiscal year ended February 2020.

- EPS 88c, down -8%.
- Book value per share 631c.
- 15% return on equity. A cyclical business at the lower end of the cycle.
- Strong cash generation and solid balance sheet with low gearing.
- Approximate 8-year development pipeline secured.

After stopping construction during the lockdown, Balwin resumed operations beginning June. The long-term outlook remains promising. Stock is trading at 3 times PE and less than 50% price-to-book.

PSG Group

An entrepreneurial group with a portfolio of high quality, high growth, scalable, SA focused companies including banking, wealth management, asset management, insurance, private education, energy utilities and services, and retirement lifestyle villages.

PSG announced that they are pursuing the unbundling of their 28% share in Capitec by way of a *pro rata, in specie* distribution to PSG shareholders. The move will give us direct ownership in Capitec, which we effectively acquired at a discount via PSG, and should narrow the stock's remaining discount to its sum of the parts.

Capitec

One of the largest and the fastest growing banks in South Africa.

- Reported results for the fiscal year ended February 2020.
- EPS 5 428c (or R54.28), up +19%.
- 28% return on equity.
- 13.9 million active clients, up +22%.
- 73% of the growth in earnings was driven by diversification (non-term loan products).

Long runway. Further opportunities in market share gains, credit cards, business banking, and funeral policies.

Conclusion

I believe there is downside risk in the S&P 500 from current levels. At the same time, I believe Desert Lion's opportunity set is relatively cheap and the USD/ZAR exchange rate offers an advantageous entry point. The fund is almost fully deployed as we view the current risk-reward profile and expected returns as appealing.

To our partners, thank you for your loyal support. The quality of a fund is deeply dependent on the quality of the partners. It has been a bumpy ride in the markets, and you have exceeded all my expectations with your commitment to Desert Lion's long-term focus. It certainly bodes well for our future.

To other readers, if you are an accredited investor and interested in joining the fund, you are welcome to contact Ally (InvestorRelations@desertlioncapital.com) or me directly (rudi@desertlioncapital.com).

All the best,

Rudi van Niekerk

APPENDIX A: PERFORMANCE
Q2 REPORT FOR THE PERIOD ENDED JUNE 30TH, 2020

	Desert Lion Capital Fund I (1) %	FTSE/JSE All Share Index (2) %	MSCI Emerging Markets (3) %
Q2 2019 (4)	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)
Q2 2020	12.8	25.8	18.1
Cumulative (5)	(30.7)	(19.6)	(2.9)
Annualized (5)	(25.4)	(16.0)	(2.3)

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)

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.