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3Q23 Investor Letter

Dear Co-Investor

In the dramatic theatre of business, relentless motion and constant change make an exhilarating narrative. At SaltLight, we approach investing as a serene nature documentary filled with patience and thoughtful observation. In our view, frequent portfolio reshuffling is not a badge of honour, but rather restlessness. Each portfolio adjustment is a step into murky water, exchanging the known for the unknown, and as such, we set a high threshold for action.

This quarter, we can report our activity was relatively subdued. Our portfolio companies are grinding along our hypotheses and in some cases, surpassing our expectations.

As we step away from the tranquillity of a long-term horizon, we are immediately met with a discord of short-term news. The market's narrative is loud and unsettling – filled with concerns about rising rates, looming recession fears, and geopolitical unrest. Forecasting these macroeconomic thunderstorms is not our game.

We're more inclined to drill deep into the bedrock of a business, to fasten on to its durable strengths, pondering what the business might look like in the year 2028.

Why do we keep talking about 2028? Building a business is a long-term endeavour: an exercise in grit and patience, seeing the unseen, and having the intellectual honesty that when crafting something that matters – the journey never traverses a straight line. One of the most powerful inputs to success is... *time*.

In this letter, we briefly talk about a few portfolio companies: SEA Ltd, MercadoLibre, Karooooo, Transaction Capital and, lastly, Purple Group. We also give an update on some changes to our fund name and our administrator.

It Takes Time

Our own experience with building businesses is that execution needs to be consistent, but the results can be lumpy.

To keep one's focus fixed on the path ahead, one must balance the present '**what is**' against the potential of '**what could be**' and the possibility of '**what might not be**'.

'What is'

'*What is*' reflects the reality that every enterprise will inevitably face its share of speed bumps. In such times, the market is likely to stare with an open mouth at the immediate challenges (such as rising interest rates, falling consumer spending or a drop in earnings) without considering whether the injury is a fleeting gash or a terminal wound.

When (not if) turbulence hits our businesses, our involuntary reflex is to cast our thoughts 18 months ahead. *Could the problems still be present then? Could they be diminishing? Is the problem controllable and fixable?* Conversely, we've observed that our peers prefer to cut and run to the next thing that is not blemished with uncertainty. Particularly, in hedge fund-driven markets such as the US, we've been astounded by

how much opportunity there is (and this has shown up in some of our returns) by just having a two-year investment horizon – never mind a five-year one.

We believe that the path to success in compounding capital is to maintain a brace position during storms and wait for it to pass.

So, what storms could pass? It's conceivable to us that central banks could be cutting interest rates 18 months from now. In South Africa, it's not far-fetched to foresee a significant reduction in power cuts, reducing diesel costs and restoring productivity. We don't claim to possess any prophetic powers, but we resist the urge to project today's anxieties onto tomorrow.

'What Could Be'

Much of our portfolio is skewed to emerging companies ascending their S-curve. We're drawn to these opportunity sets because of the uncertainty inherent to their ascent and it is within this fog of unpredictability that mispricing often lurks.

The apprehension that uncertainty stirs, coupled with the patience required for such investments, daunts many. Some business models require an extraordinarily long time to build. A prime example: e-commerce marketplaces.

As we detailed in our [4Q21 letter](#), marketplaces are not built in a day; they command over a decade to cultivate scale and network effects. For the companies themselves, it requires a 'Stalingrad' mentality to finish the race.

Consider **SEA Ltd** (SEA) and **MercadoLibre** (MELI) who are two of our e-commerce businesses.

MercadoLibre

MELI is the more established business, founded in 1999 during the Dot.com bubble by Marcos Galperin. Eight years later, it went public in 2007 at \$17, and in the optimistic era for emerging markets, rose to \$84 shortly after that. A year later, the GFC started and MELI collapsed from \$84 to \$8 (*oh my!*).

Despite violent bouts of volatility over the years, since listing, MELI has returned 81x capital invested. However, the accounting records have only demonstrated double-digit operating margins and worthy returns on capital in the last two years - twenty-four years since founding!

It's worth noting that MELI has weathered many foreign invasions of competition, including incursions by the Imperious Amazon. It has survived and thrived despite Argentina's challenging macroeconomic climate. One example: MELI leveraged its e-commerce network effects into FinTech services. In Argentina, over a fifth of the population,¹ has a MELI high-interest account as a bulwark against inflation.

We have been rather fortunate to have invested in MELI two years ago and have participated in the part where MELI's dominance, profitability and growth prospects have become obvious. It's true to say that uncertainty about MELI has significantly reduced. However, there is an unsatisfying fact: during the galling and volatile 'uncertainty' phase when investors had to imagine '*what could be*' we did not

¹ Source: [Bloomberg](#)

participate in the 80x growth that was on the table. As we often say: **the money is made in the uncertainty**.

We still expect satisfactory returns despite MELI's success given that LatAm e-commerce and financial services penetration is relatively low.

SEA Ltd

SEA Ltd (SEA) is a much younger company, with its e-commerce marketplace starting in Southeast Asia in 2015. The share price on the journey has been as volatile as MELI's. Similarly, SEA is weathering several doubts about new waves of foreign competition, business economics and the business model. For long-term investors looking for extraordinary returns, this is the natural state in the 'uncertainty' phase.

We remain focussed on *what could be*, acknowledging that we're in for a long journey ahead.

What Might Not Be

Here is a quick update on our 'Distressed Five' South African portfolio. We must be clear that our foray into the Distressed Five Portfolio is not a rosy belief in the macroeconomic or political fortunes of the country turning around (in fact, quite the opposite).

We hypothesise that too much negativity is being priced in. Last quarter, we wrote:

The general principle of investing is that good things need to happen. Distressed investing, conversely, is usually about widely anticipated negative events that do not materialise.

Our collection includes a distressed portfolio of businesses that are a unique breed of "survivors" and "thrivers" amid entropy. These are five highly researched, highly asymmetric opportunities.

Make no mistake about it, some of these portfolio companies are priced as 'distressed' assets but scratch the surface, and there are robust businesses underneath. Our wager is that the market has over-weighted the likelihood of negative outcomes.

What we are primarily seeking is for the perceived risks to be mitigated over the next two years. If just two or three of these opportunities pan out as anticipated, the return on this portfolio should adequately compensate for the risks taken.

Karooooo

Karooooo (KARO), our highly cashflow-generative telematics SaaS business is not one of the 'Distressed Five' but recent events offer an opportunity to draw a thread to one of the Five – **Transaction Capital**.

During the quarter, Karooooo decided to discontinue its second-hand vehicle business Carzuka.

To be honest, [we harboured](#) some reservations from the outset that Carzuka would acquire meaningful market share without investing a significant amount of shareholder

capital. Our insights are mostly gleaned from our investment in the largest competitor - WeBuyCars (owned by Transaction Capital).

In the vehicle retailing market, margins are notoriously slim. The pivotal drivers are inventory turns and the management of working capital. Scale is a decisive advantage, and a smaller entrant like Carzuka is inherently disadvantaged when the product sold is a commodity (WeBuyCars: 12,000 bays vs Carzuka: 2,000 bays).

At 6x the size, WeBuyCars can spread its marketing budget over 12,000 vehicles (vs. 2,000). From a buyer's perspective, this scale differential meaningfully alters the buying experience. The scaled player has the widest selection across brands, models, and price points. The knock-on effect is that this 'scale flywheel' contributes to inventory turnover and returns on capital. Carzuka's only lever in such a competitive landscape was pricing, where it inevitably faced compromised margins.

While the cessation of Carzuka involved an operating loss of R-77 million, the silver lining is the anticipated liberation of R110 million in working capital over the coming year.

We hold in high regard companies that strive to create a Second Act. Yet when such ventures falter, corporate entities often linger too long before terminating the underperforming segments, perhaps due to internal politics or the egos involved. Founder-led firms, on the other hand, are typically more decisive.

Transaction Capital

Karoo's unsuccessful Carzuka foray reaffirms our thesis in WeBuyCars (and **Transaction Capital**). With Carzuka's chapter closed, we anticipate a reinstatement of Karoo's impressive economic performance in the ensuing year.

Now, we believe that **Transaction Capital** remains a deeply undervalued asset. The share price remains highly volatile (from quarter end to the date of writing, the stock is up 57%).

The return of Jonathan Jawno to the helm as CEO is a welcome change. Founders typically provide the decisive action necessary to break corporate inertia. In the announcement of his return, there was an explicit statement of "unlocking shareholder value"². We look forward to more details in the coming weeks when they release their annual results.

Our data shows that WeBuyCars has drastically reduced its inventory over the last few months (which should mean a substantial increase in free cash flow). The company seems to be managing the difficult economic environment well: the median inventory holding rate is still within normal levels.

While we brace for a dip in earnings, attributable to subdued unit volumes, our perspective is that management's current priority on risk mitigation and the generation of cash flow is both prudent and strategic.

Purple Group

In our last quarterly letter, we wrote about **Purple Group** (70% holder of **Easy Equities** (EE)). We highlighted that EE's success was due to its mission to democratise

² <https://www.businesslive.co.za/sens/460711/>

investing. Their focus is serving the long-tail retail investing market (namely younger investors with small asset bases). Our vision of '*what could be*' is driven by the 830,000 active client base.

Brokerage businesses don't require much capital to grow other than the cost of customer acquisition (COVID-19 added 80% of their active base for little cost). There is little foresight required to imagine that these young investors' disposable income will grow over the next 30 years.

The downside of a brokerage business – while requiring little capital – is that trading is a voluntary activity and in recessions, customers don't trade. Over the last year (and we forecast into the next year) we're going to see a decline in revenue whilst fixed costs have expanded as EE has invested in growth opportunities³.

We were therefore pleased about EE's recent unveiling of a 'carrot and stick' fee model to balance the voluntary nature of activity revenue. The fee is designed as a behavioural loyalty program, imposing a nominal fee, waived upon either regular financial investment (not trading) or non-monetary contributions. Either way, a client would need to engage with EE once a month.

The most interesting outcome of the announcement has been the national 'outrage' ([here](#), [here](#), [here](#), [here](#), and [here](#)). Whilst many would disagree, our view is that this is indicative of an ascending national brand and an encouraging place in the Zeitgeist.

While there might be a risk of customer attrition due to this new fee, the long-term implications for shareholder value cannot be overstated. It recalibrates the unit economics for customers acquired during the pandemic, lending a degree of sustainability to EE's business model that was previously absent.

In the Philippines, while regulatory approvals have been slower than anticipated, EE's proactive stance is evident in their innovative customer acquisition strategy, leveraging a 'mock investing competition' that has already attracted a substantial user base (330,000). This approach not only makes hay during the regulatory waiting period but also plants seeds for low-cost customer acquisition.

³ 53% of revenue at 1H23 is activity-based revenue.



Astute observers will have discerned a subtle yet significant change: our fund has been rechristened as the SaltLight Worldwide Flexible Fund. This evolution comes on the heels of Apex Group acquiring Sanne, our Manco, which led to the transition to the FundRock brand.

We've been particularly pleased with this development as the fund's administration has moved to Apex Fund Services South Africa Ltd (previously Maitland) – a distinguished leader in the field within South Africa. The benefits of this move have been multifaceted: enhancing our portfolio management systems, bolstering our operational infrastructure, and elevating our risk management function. RMB and JPMorgan remain the custodians of our assets and liquidity. Looking ahead, we will be welcoming Deloitte as our auditors in the forthcoming financial year.

As we always remind investors, most of our liquid wealth is in the same fund as yours. We share in the inevitable ups and downs right with you. Please free to reach out if you have any questions.

David Eborall
Portfolio Manager

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