Constantia Investment Partners

# Interim Letter
2020

Dear fellow investor,

The second quarter of 2020 surprised most investors, with risk assets rallying strongly from their March lows. The initial phase of the rally was most likely due to the huge quantities of monetary and fiscal support provided by central banks and governments to forge a path for their economies and population to a more normalised environment beyond COVID-19. However, recent economic data has begun to improve from extremely depressed levels, leading to at least some justification for optimism.

The path for markets over the rest of 2020 remains dependent on how successful countries are in containing the spread of COVID-19. The more successful the lockdown phase, the sooner social distancing restrictions can be relaxed, which leads to an improvement in economic activity. Governments around the world are acutely aware of the economic impact of extended lockdowns, and therefore seek to balance these priorities.

However, since the decision between re-opening economies or re-entering lockdown is ultimately made at a political level, we must recognise the limitations of our own ability to forecast how the next six months plays out. The three variables that will drive markets – public health, economic growth, and political will – are not independent of each other. Success (or lack thereof) in any one variable will change how the other two variables react and are prioritised.

In an abstract sense, this is an example of what is known in physics as a ‘three-body problem’. In attempting to predict the motion of three bodies through space (originally conceived of as the Earth, Moon and Sun), physicists realised that the mass, velocity and position of each body has a significant impact on the subsequent motion of all bodies in the system being analysed.

Of course, even this analogy may be too simple, because it ignores how the individuals making up an economy may choose to react. It is one thing for mandated social distancing restrictions to be relaxed, but quite another for people to feel safe and comfortable in engaging in out-of-home economic activity. These are behavioural decisions taken at the micro-level – “am I or someone in my direct family unit at higher risk of infection, meaning I will choose to stay at home for longer?” – and therefore not easy to model with any great degree of confidence.

Our response has been to focus on the businesses we own: to make sure they can survive the immediate disruption from a liquidity and solvency point of view, and to understand what events need to play out that would make us change our mind regarding our long-term investment thesis.

## Noteworthy Changes in the Fund

Over the course of this quarter, we chose to concentrate the portfolio into fewer names. In certain cases, where we believed some of our businesses had exposure to similar end-markets or drivers of demand, we elected to only hold the business where we have the higher conviction or best risk/reward trade-off.

The most material addition to the fund over the quarter was a new position in Berkshire Hathaway, which we started to from the end of March. In Berkshire, we believe we have exposure to a wide range of businesses that will be sensitive to improvement in the US economy when the COVID-19 crisis abates.

While the popular perception of the company is frequently that it is a portfolio of listed equities, the reality is that Berkshire has substantial operations in the insurance, railroad, energy, manufacturing, and retail sectors. Many of these businesses occupy specific niches and enjoy strong returns on capital. Critically, Berkshire has a fortress balance sheet, meaning that it can provide internal funding to any of these businesses, should the need arise. And, of course, there is the optionality of Messrs. Buffett and Munger making a substantial acquisition, should the opportunity present itself. Even if they do not make such a purchase, we believe there is meaningful opportunities for value-creating capital allocation decisions.

As a source of growth in intrinsic value derived from different end-market risk, we believe Berkshire provides good diversification to the Fund.

## Performance to 30 June 2020

| | GHCF | Benchmark |
|---|---|---|
| Financial Year 2020 | +9.9% | +2.2% |
| 2020 (Calendar YTD) | +4.3% | -3.8% |
| 2019 (Strategy Inception: 31 Aug. 2019) | +5.3% | +6.3% |
| Cumulative Since Strategy Inception | +9.9% | +2.2% |

*Total returns shown for the AIM Global High Conviction Fund have been calculated using exit prices after taking into account all the product's ongoing fees and assuming reinvestment of distributions. No allowance has been made for entry fees or taxation. Past performance is not indicative of future performance. Benchmark is MSCI World Net Total Return in AUD (source: Apex Group.)*

## Conclusion

As we head into the second half of 2020, the only forecast we are 100% certain of is that there is more volatility in store. As markets digest the economic disruptions and challenges caused by COVID-19, we are certain there will be no shortage of short-term concerns driving asset prices.

As already mentioned, our response is to stick to the fundamentals and focus on the businesses we own. As long as they can remain liquid and solvent, and their long-term competitive position is not adversely affected by the pandemic, we believe that moments of volatility are best used to deploy some of the cash we still hold. If we wait for the 'all-clear' signal, we will likely have missed our opportunity.

The rest of this letter will focus on a stock insight into Prosus, as the fund's singular exposure to the Chinese tech sector.

At the back of this letter, there is the usual addendum containing our quality scorecard, internal sector allocation, geographic revenue exposure, and the top ten holdings.

We wish you and your loved ones safety and good health during these strange times. Rest assured that we are focused on our portfolio of businesses, and we will keep you updated of our progress.

*Kind regards,*

*The Constantia investment team*

## Chinese Internet with Emerging Market Optionality – Prosus

*by Etienne Vlok*

*We first highlighted Prosus to you in a March 2020 update. At the time, we mentioned that it is an Amsterdam-listed holding company with a substantial investment in Chinese internet giant Tencent, among its other assets. Given the scope of what was happening in the world in March and April, we did not fully delve into the business. We did however commit to revisiting Prosus in a future note.*

In 2001, South African media conglomerate Naspers purchased a 46.5% share of Tencent – then an unknown Chinese internet start-up – for the sum of $32mn. Today, Tencent needs little introduction: after listing on the Hong Kong stock exchange in 2004, it has solidified its position as one of China's internet giants, providing a wide variety of online services to a substantial user base.

By 2018, the value of Naspers' investment in Tencent had grown to exceed $175bn – arguably one of the greatest compound returns enjoyed by any early-stage investment ever. However, as the value of Naspers' investment in Tencent grew, it began to dwarf the other operating businesses Naspers owned: primarily the Multichoice satellite television network (with reach across much of sub-Saharan Africa), legacy South African print media assets, and a wide portfolio of investments in other listed and unlisted emerging market internet companies.

Over time, Naspers stock began to trade at an increasingly wide discount relative to the value of its underlying investments, likely for two main reasons.

Firstly, Naspers came to dominate the Johannesburg Stock Exchange All Share Index, peaking at an index weight north of 20%. Most South African institutional investment managers have single stock limits around 10%, meaning local funds were persistent net sellers of Naspers stock even as Tencent continued to appreciate in value.

Secondly, Naspers has a reasonably complex corporate structure that provides the holders of a non-public class of stock with superior voting rights, effectively meaning public shareholders cannot outvote management. (This structure is comparable in consequence to those implemented at many US internet businesses, such as Alphabet and Facebook). This structure, combined with the volatility of the South African rand, meant that global or emerging market investors faced with a choice between owning Tencent directly (in Hong Kong) or indirectly (through Naspers in Johannesburg) mostly chose the former option, despite the wide discount the latter was trading at.

To be clear, some level of holding company discount is warranted. However, depending on the valuation assigned to the operating businesses and investments other than Tencent, Naspers stock was trading at somewhere between a 20% and 50% discount to the value of its underlying assets.

In 2018, management initiated a process to address this discount to net asset value.

- The first step involved unbundling the Multichoice satellite television business into a separately listed entity on the JSE, meaning that the remaining assets inside Naspers were predominantly non-South African internet businesses.
- Around the same time, Naspers sold a small percentage of its Tencent investment in the open market to raise approximately $10bn in cash as a war chest. It still owns around 31% of Tencent.
- Finally, Naspers resolved to unbundle the entire investment in Tencent, the investments in non-South African internet businesses, and the majority of the cash raised from selling down its stake in Tencent into a new entity, to be listed on a European exchange.

The new entity, called Prosus, started trading in Amsterdam during September 2019. Naspers remains the majority owner of Prosus stock, but the Dutch listing makes the business available to a much wider pool of potential investors.

As Tencent remains both the largest asset and source of cash inflow (via its dividend), an investment in Prosus must by necessity evaluate Tencent first.

We are optimistic regarding the outlook for Tencent. We believe the most valuable asset the business has is the WeChat ecosystem, which has become central to Chinese consumers' day-to-day digital life. While WeChat has expanded well beyond being a messaging service, the powerful network effect of the core messaging product serves as the glue that keeps users engaged. On top of this, Tencent has built a multitude of other products and services that are monetised via different models. Of particular interest to us is the payment and wealth management businesses, which we believe has scope to grow substantially over time. Tencent also houses a nascent cloud business which predominantly serves corporates in China. While we think this will take some time to scale up, we believe that the Chinese cloud landscape will ultimately end up with Alibaba and Tencent having dominant market share. At scale, we think the economics for both these businesses can be attractive.

Still, why own Tencent via Prosus, rather simply going directly to the listing in Hong Kong?

To us, a large component of the Prosus investment case lies in the portfolio of other unlisted internet businesses it owns. Many of these businesses have leading market positions in specific online verticals (such as online classifieds, payments, or food delivery) in several highly populous emerging markets (for example India, Brazil, Russia, and Indonesia, to name just a few). To take a longer-term view, these countries are the source of the next billion internet users. Management has a track record of disciplined investment in and scaling of online platforms that end up being local winners, and we believe they can continue to execute to this plan.

As such, our decision to prefer Prosus came down to valuation and optionality. Depending on how one views the discount, we are either buying Tencent at a reasonable margin of safety and getting a optionality on a host of fairly unique emerging market internet assets for very little cost, or we are getting access to the entire portfolio at a substantial discount to intrinsic value.

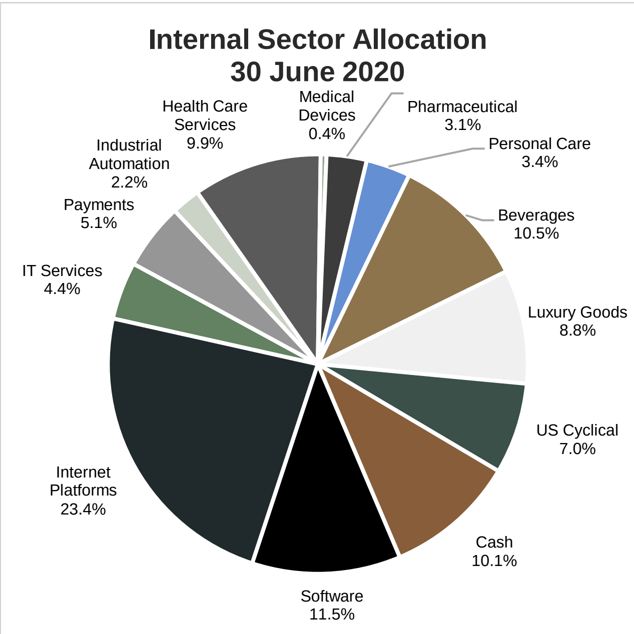
We first started to build a position in Prosus during the 4th quarter of 2019. We believe Tencent and its portfolio of investments are set to appreciate in value over time.

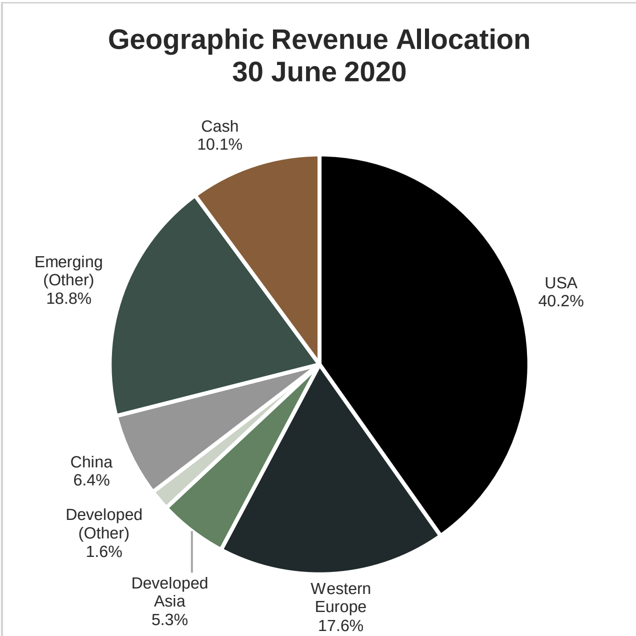
# ADDENDUM

## Quality Scorecard

| Portfolio Characteristic | |
|---|---|
| *Profitability* | |
| Gross Margin | 51.9% |
| Operating Margin | 20.7% |
| Free Cash Flow Margin | 17.8% |
| *Returns on Capital* | |
| Return on Assets (ROA) | 13.2% |
| Return on Equity (ROE) | 29.0% |
| Return on Invested Capital (ROIC) | 22.5% |
| *Leverage* | |
| Debt/Equity | 79.7% |
| Net Debt/Equity | 17.8% |
| *Valuation* | |
| Free Cash Flow Yield | 3.8% |
| 12m Forward Free Cash Flow Yield | 4.1% |
| 24m Forward Free Cash Flow Yield | 4.9% |
| *Holdings* | |
| Number of positions | 25 |
| Active Share | 82.7% |

## Internal Sector & Geographic Revenue Allocation




*Source: FactSet, Constantia analysis.*

## Top Ten Holdings (alphabetical)

| Business | Sector |
|---|---|
| Alphabet | Internet Platform |
| amazon | Internet Platform |
| Berkshire Hathaway Inc. | US Cyclical |
| Coca-Cola | Beverages |
| Heineken | Beverages |
| ICON | Health Care Services |
| Microsoft | Internet Platform |
| mastercard | Payments |
| prosus | Internet Platform |
| UnitedHealth Group | Health Care Services |