11 September 2024

2Q 2024 Co-Investor Letter

Calendar Year Results:

	Fund Return[1]
2020	3.42%
2021	18.09%
2022	-34.25%
2023	30.82%
2024 – YTD 2Q24	17.32%

Dear Co-investor

The SaltLight Worldwide Flexible Fund returned 7.38%[1] in the second quarter of 2024.

In some respects, 2024 is turning out to be a solid year. Some highlights:

- Our shift from AI infrastructure to AI software beneficiaries continues to deliver healthy returns on capital. The positive aspect is that we're seeing real profits being offered.
- Our 'Distressed 5' South African companies showed some strong performance as sentiment improved after the May elections and the formation of the Government of National Unity (GNU).
- We are a ZAR-denominated fund, yet 80% of our capital is allocated to global securities. A strong ZAR keeps us up at night because it can diminish our hard-won foreign currency returns. We have hedged the currency on some of our offshore exposures to mitigate this effect.

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Predicting short-term market movements is a fool's errand in our line of business. Therefore, we steer away from any predictions on what markets will do over the coming quarters or next year. We prefer to spend our energy divining what the world could look like in 2029.

With such an extended horizon, we're typically concerned about matters most of our peers don't have to consider. But, without question, we'd take on this intellectual puzzle rather than trying to predict next quarter's earnings or when the Fed will cut rates.

Here we are, 18 quarterly letters later since the inception of our firm. We aim to articulate the philosophies and tactics we employ in stewarding your capital—capital you've earned through toil and sweat. Yet, it's not merely work for us; it's a passion. We are to the business world what sports fans are to their arenas, endlessly debating the finer points of outstanding plays and tactical finesse until the wee hours.

[1] *SaltLight Worldwide Flexible Fund Class A1 return*

In this letter, we will share our thoughts on capital allocation, a discipline indispensable for enduring success in investing. Then, beyond capital allocation, we'll dive into a discussion about “second acts”. We'll weave this discussion through our analysis of portfolio companies, hoping that it might catch the eye of a CEO or board member who could glean valuable insights from our perspective.

Most Companies Don’t Matter at All

We believe the secret sauce to building wealth is finding a company that can keep growing its free cash flow with little extra capital and still churn out high returns on that capital for many years to come (“compounders” in investing parlance).

It's a fantasy to believe that identifying 'compounders' in advance is straightforward. It's like navigating a maze blindfolded—you know there's an exit, but actually finding it is an entirely different challenge.

James Andersen, former manager of the Scottish Mortgage Fund, makes a challenging point: “**Most companies do not matter at all and do not over the long-term produce returns**”.

However, a company that can do capital allocation well will have a greater chance of being one of the few that does produce long-term returns. Poor capital allocation is poison to long-term returns—it's a graveyard for potential. And so, if an investor is dedicated to the art of finding a potential compounder, one must also master the skill of identifying wise capital allocation. There’s simply no alternative.

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Capital Allocation

First, let’s consider the overarching topic of capital allocation. Every board and management team - let’s call them "managers" for simplicity - are required to make intelligent decisions about how to allocate a business's profits.

They have two options: plough profits back into the business in the hope of generating further profits or return them to shareholders through dividends (or share repurchases).

But managers are often dreadful at capital allocation. Warren Buffett, in his 1987 shareholder letter, was scathing:

> *“Heads of many companies are not skilled in capital allocation. Their inadequacy is not surprising.*
>
> *Most bosses rise to the top because they have excelled in an area such as marketing, production, engineering, administration, or, sometimes, institutional politics. Once they become CEOs, they face new responsibilities. They now must make capital allocation decisions, a critical job that they may have never tackled and that is not easily mastered. To stretch the point, it's as if the final step for a highly-talented musician was not to perform at Carnegie Hall but, instead, to be named Chairman of the Federal Reserve.*

> *The lack of skill that many CEOs have at capital allocation is no small matter: **<u>after ten years on the job, a CEO whose company annually retains earnings equal to 10% of net worth will have been responsible for the deployment of more than 60% of all the capital at work in the business</u>**.*
>
> *CEOs who recognise their lack of capital-allocation skills (which not all do) will often try to compensate by turning to their staffs, management consultants, or investment bankers. Charlie and I have frequently observed the consequences of such "help."*
>
> *On balance, we feel it is more likely to accentuate the capital-allocation problem than to solve it. In the end, plenty of unintelligent capital allocation takes place in corporate America. (That's why you hear so much about "restructuring.")"*

Our experience is that many capital allocation missteps stem from disastrous second acts. This is our next topic.

Every Business has a Story

When analysing a business, we find it helpful to dissect its story into parts: first acts and subsequent acts.

First acts are generally the first products or services in a <u>defined market</u> that ushered the business to success. Occasionally, the market's breadth allows that initial offering to remain the company's cornerstone, as with **Karooooo** (KARO), where telematics has been the focus since its inception.

The **Second act** is the next chapter of the business (the iPod, Amazon Web Services, or an acquisition on a different continent). To generalise, it is a new line of business, a new geography, or a new product or service. The Second Act, in theory, is designed to extend the longevity of a company and, if executed successfully, enhances a CEO's brand and sharpens their strategic acumen. However, get it wrong, and it can be tantamount to career suicide.

Managers face the same challenge as 17th-century explorers who ventured into uncharted seas; no significant body of knowledge today provides clear guidance on navigating the oceans. Perhaps this is why many managers find themselves metaphorically lost at sea or economically shipwrecked.

Hamilton Helmer, whom we regard as one of the most astute business strategists of our time, recently shared his thoughts on this subject on a podcast[2] (we hope he turns his insights into a book). We will borrow his thoughts liberally throughout this letter and encourage readers to listen to the podcast[3].

Heeding survivor bias, it's evident that many second acts do succeed. Helmer's research, which focused on the top 100 public companies during the mid-2000s, sought to determine how much of their profits stemmed from their first or second acts. Interestingly, he discovered that second acts accounted for half of the profits at these leading firms.

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[2] *Acquired Hamilton Helmer & Chenyi Shi on How to Build an AWS-Like Second Business link*

[3] *Our sincere appreciation to Helmer and Chenyi Shi for being so generous with their knowledge*

The two key ideas Helmer provides are: (1) The default capital allocation choice should be for companies to reinvest to expand their Powers. (2) If they can't, the Second Act should be based on some crucial factors around competencies and customer needs.

First Extend Powers in the First Act

Recall that capital allocation involves a decision about where to reinvest profits. But where should this capital go? A new product, a new feature, a new store or a new country? Helmer suggests that managers broaden their thinking beyond a narrow perspective of bolt-on products or services to what he terms a "Power umbrella."

But first, what is Power? Helmer thoroughly explains his thinking on these Powers in his compelling strategy book[4]. Since we don't have space to go into much detail, we will provide a quick summary in the appendix to this letter but encourage folks to buy his book.

Helmer defines Power as "*a set of conditions creating the potential for persistent differential returns*". It is a thoroughly academic definition, but the essence is a set of factors that create shareholder returns that persistently exceed the cost of capital.

He further theorises that there are **only seven powers**, and the businesses that own one or more of these powers stand the best chance of withstanding competitive pressures and thereby persistently generating above-average returns.

Amazon is a quintessential example of building on power (in their case, scale economies). Their revolutionary e-commerce model involved sharing the benefits of scale economies with consumers (remember Jeff Bezos saying, *"Your margin is my opportunity"?*).

This approach made it exceedingly difficult for subscale competitors to replicate the model without incurring significant economic losses. Nick Sleep describes this "flywheel" strategy: *"Increased revenues begets scale savings begets lower costs begets lower prices begets increased revenues."*

Two side notes: First, GAAP accounting failed to point investors to the growing power that Amazon was extending. Instead, investors saw ongoing and sustained accounting losses with little noticeable hope of profitability.

Second, to emphasise the "power over products" point, notice that Amazon's scale economies engine was not anchored on defined products but on its entire business system, leaving an endless runway to tack on categories over time, from books to dog food.

That said, a business can reach the boundary of an opportunity set, where markets mature, customer habits change, or macroeconomic factors constrain growth.

[4] *7 Powers: The Foundations of Business Strategy:* [link]

Suppose the reinvested profits do not go into opportunities that ultimately end in satisfactory incremental returns on capital. In that case, it's time to return excess capital to shareholders or venture into a second act. *But what should be considered*?

The Second Act

Venturing down the second act essentially forms a new enterprise. Outcomes resemble a power law-like distribution of a few "home runs" and a long tail of "losers". Shareholders must underwrite the principle that failure is a natural part of the journey once a company goes down the path of a second act. *What could increase the chances of success?*

There are many factors to consider, but Helmer believes the key decision inputs are 1) **organisational competency** (he calls them organisational skills) and 2) whether the business is serving **existing or acquiring new customers**.

Helmer provided this helpful matrix on the mentioned podcast to decompose second-act decisions.

The critical point is that "Co-action" is the most fertile ground for second acts to succeed.

Here is some helpful background to each block:

Current Business (Same Customer Needs, Same Skills)

- This represents our core business as it stands today.
- It's where we have established expertise and market presence.
- Note: The first prize is to extend a company's power umbrella

Reinvention (Same Customer Needs, New Skills)

- This involves developing new capabilities to serve existing customers better.
- While it presents opportunities, they are often smaller in scale.
- Challenge: often face "organisational inertia" here, as decision-makers are accustomed to old methods (and control the P&L).

Co-Action (New Customers/Needs, Same Skills)

- This strategy leverages our existing skills to serve new customer bases or address new needs.
- It's an exciting area for growth that builds on our core competencies.

Diversification (New Customers and Needs, New Skills)

- This represents venturing into unknown territory.
- While potentially rewarding, it comes with high risks and typically low odds of success.
- It requires careful consideration and resource allocation.

Investing in Second Acts

We've established that second acts have higher risks and a power-law-like distribution of outcomes. *How can investors be discerning about 'investable' second acts?*

At SaltLight, we dedicate what some might consider an excessive amount of time to studying corporate second acts—an intellectual fetish that we can't shake.

Misunderstood second acts can be a fertile source of overlooked opportunity as our peers find comfort in what fits well in spreadsheets and looks good in the accounting records.

We believe that accounting records must eventually show profits (more importantly, free cash flow), but they are *ex-post* indicators of success. Instead, our approach is more qualitative in nature.

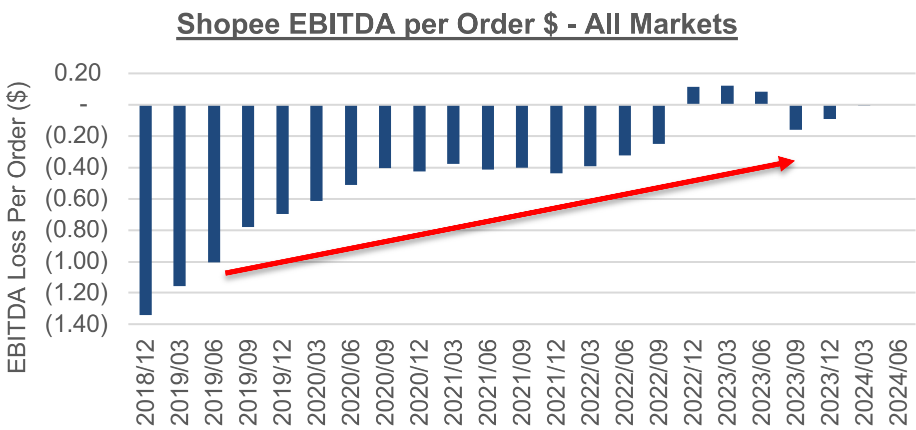
We decompose a company's core competencies and assess its ability to extend its existing power or develop power elsewhere. Often, the best indicator of "second act" success is to look at previous successful acts.

Sea Ltd (SE)

SEA Ltd leveraged its ability to build audiences in gaming (an incredible skill in the digital platform world) into the largest e-commerce business in Southeast Asia (Shopee). After that, it leveraged its e-commerce customer base (customer needs) into a sprawling FinTech business with banks and other financial services.

We saw growing powers and a track record of invention. The company invested heavily through their income statement to develop the network effects common in e-commerce marketplaces. On the other hand, our peers seem to focus on multi-year periods of profit ambiguity.

We thought a helpful way to see the "scale economies" power in actions is to see the EBITDA loss per order over time. New entrants and smaller competitors need to endure this to compete.



From our vantage point, this power-building phase appears to be nearing its end. Management has guided that Shopee will be adjusted-EBITDA positive for the next quarter.

It has taken a long time, yet success is still not assured. However, stepping back, this business is in a robust regional position with three significant opportunity sets to compound shareholder capital over time. We expect free cash flow to follow in due course.

Brookfield (BAM/BN)

Brookfield is another interesting story of multiple acts that could rival Madonna in corporate reinvention.

Brookfield was founded in 1899 as a Brazilian utility provider. In the 1950s, it morphed into an investment holding company called Edper Investments[5], which became Brascan. In 2005, Brascan became Brookfield Asset Management (BAM), where BAM started managing third-party capital (today managing $1trn of assets under management).

[5] *Edper investments nearly collapsed in the early 1990s.*

We've spoken about Brookfield and its insurance businesses before (see our 1Q22 letter), but one of the exciting areas that Brookfield is deploying capital into is energy.

Last quarter, we discussed AI's high energy intensity. Brookfield believes (and we concur) that an unprecedented electricity build-out is required over the next two decades. They provided some numbers in a recent letter to shareholders[6].

> *… the global installed capacity for electricity is approximately 8,000 gigawatts. To meet expected demand, this installed capacity will need to expand to more than 20,000 gigawatts in the next 20 years. In addition, nearly half of what exists today will need to be retired, as it is very carbon-intensive. Said differently**, we need to more than double the current capacity (which was largely built over the past 50 years) while also replacing approximately 50% of what we have**.*
>
> ***Nothing like this has ever been attempted**, but it is essential in order to reach the world's net-zero goals and drive the AI revolution.*

Energy and human progress go hand in hand. With AI reaching the point where it will augment human intelligence, having sufficient power to run AI will likely become a strategic imperative. Gigawatt-size data centres will likely be on the horizon in the next few years.

Brookfield is a significant player relative to its size but insignificant on an absolute basis. It controls around 250 gigawatts through renewables platforms (~3% of global installed capacity and equivalent to seven Eskom's).

During the quarter, Brookfield announced a $10bn, 10.5-gigawatt power contract with Microsoft—the largest of its kind. However, this additional capacity is a drop in the ocean, considering the 20,000 gigawatts needed over the next 20 years.

Here is the problem: *who will fund it, and who can build it?* Governments are in a perilous fiscal debt situation. The scale of capital required to build the global electric generation and transmission capacity is hundreds of trillions. Therefore, the private sector will likely have to fund a large portion of the build-out.

Brookfield has been building up its energy platform to tackle the funding and operational elements of the demand problem. Recently, it has acquired ten renewable operating and development platforms.

Was this a good capital allocation decision? Reverting to our Power framework, let's consider Brookfield's core competencies: deploying capital, operating 'real assets', and raising substantial funds. Notably, it has raised $100 billion over the past year and services 80% of the largest alternative allocator institutions in the world.

It should be noted that powers are valuable when operating against one's competitors within the industry. A handful of other alternative firms might indeed be able to muster significant capital, but here's where Brookfield distinguishes itself: the combination of 'real asset' investment and operating capabilities with the ability to

[6] *Source: Brookfield Corporation 2Q24 Letter to Shareholders link*

mobilise that mega-capital. This multi-functional prowess is not commonly found among its competitors.

In this vertical, Brookfield's Second Act involves acquiring energy-specific competencies on the asset side and then buying up stakes in smaller asset managers[7] to maximise value across the capital structure (e.g., private credit now has $300 bn of assets under management).

What's in it for us? Brookfield participates in the backbone of the world economy – infrastructure, power, data centres and real estate. If one had to invest in these assets directly, they would yield low returns over long durations. This kind of returns profile would not align with our preference to compound our fund's returns. However, the broader opportunity set is in the hundreds of trillions, especially as AI and energy demand converge. It is unquestionably mouthwatering.

Instead of direct project involvement, a more attractive strategy for us is to invest in an asset manager specialised in these sectors, benefiting from their scale and powers. We participate in capital-light management fees and investment returns over the investment's lifespan. Essentially, we're investing in Brookfield's power, but we also participate in the vast 'global backbone' opportunity set.

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Second Acts in business are often misunderstood and can be perilous, laden with uncertainty and the risk of substantial losses due to poor capital allocation. Many shareholders have experienced significant financial setbacks from investments gone awry. We advocate for a strategy where a business's best investment is to expand or improve upon the sectors they already understand. When venturing beyond familiar territory isn't avoidable, the decision should pivot primarily around existing competencies and customer relationships.

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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 feel free to reach out if you have any questions.

David Eborall
Portfolio Manager

[7] *Source: https://www.castlelake.com/article/brookfield-asset-management-and-castlelake-to-enter-into-strategic-partnership/; https://primarywave.com/just-announced-strategic-partnerships-with-brookfield-asset-management-and-caa/*

Appendix

Summary of the Seven Powers:

- **Network effects:** Where the value of a product or service increases with the number of users.
- **Scale economies**: Where increased production leads to lower per-unit costs.
- **Counter-positioning**: Where a newcomer adopts a new, superior business model that the incumbent does not mimic due to adverse effects on their existing business.
- **Switching costs**: Where it becomes costly or inconvenient for customers to switch to a competitor.
- **Branding**: The creation of a recognised, trusted image that appeals to consumers.
- **Cornered resource**: Control a resource that competitors cannot access or replicate.
- **Process power**: Superiority in operational processes that lead to enhanced performance and output.

Disclaimer