SaltLight Capital Management
Unit 3 Brookwood, 50 Hyde Close,
Hyde Park, Johannesburg, 2196
Telephone: (011) 268-6057
Website: www.saltlightcapital.com

3Q 2024 Co-Investor Letter

Calendar Year Results:

	Fund Return[1]
2020	3.42%
2021	18.09%
2022	-34.25%
2023	30.82%
2024 - YTD	35.64%

18 November 2024

Dear Co-Investor

The SaltLight Worldwide Flexible FR Fund returned +15.61%[1] during the third quarter of 2024.

We welcome the new co-investors who have joined our fund over the past few months. We think it is worth highlighting SaltLight's non-conventional approach to portfolio construction, which may lead **our portfolio to zig when the market is zagging**.

We are index benchmark-agnostic opportunists and target opportunities not in the present but for what the world might look like in 2029.

When constructing our portfolio, we are deliberately agnostic about index benchmarks for the primary reason that we think index benchmarks shackle our peers onto the same well-trodden opportunities.

This feature brings much freedom to be opportunists. Our worldwide flexible fund mandate, coupled with our fund size, allows us the manoeuvrability to explore the broadest opportunity set unbounded by conventional constraints.

Year-to-date fund returns this year have been satisfactory, though it's important to highlight that many of the businesses driving these results were selected 2-4 years ago. Back then, we were thinking about the world in 2025-2026. However, the process from idea to result is never as apparent when one undertakes a journey with a limited map of how things will pan out.

We expect that our current investments, which aim for the scenarios in 2029, may follow a similar pattern. They may challenge present conventional wisdom but potentially validate our approach in the years to come.

Whenever we consider the future, we leave an opening for a wide range of outcomes—and, of course, for changing our minds when the facts change.

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

SaltLight Capital Management
Unit 3 Brookwood, 50 Hyde Close,
Hyde Park, Johannesburg, 2196
Telephone: (011) 268-6057
Website: www.saltlightcapital.com

What Contributed During the Quarter

This quarter, our notable contributors included **AppLovin**, **Brait**, **Sea Ltd**, **Karooooo**, **Blue Label Telecoms** and **Brookfield Corporation**.

Many of these companies are not staples in the average portfolio. They vary widely in terms of market capitalisation and geographic presence, and many do not appear in the major passive indices. We own them because they are exceptional businesses that actively create value for their shareholders over the long term.

*****

In this letter, we discuss our broad thesis about the game industry's future. Game media has been an attractive industry to own over the last two decades for reasons we will discuss.

However, the industry is now mature, growth is slowing (2%-4%), and the economics are changing for many participants.

We hypothesise what the industry could look like in a couple of years and then mention a few of our portfolio companies (**AppLovin, Tencent, Roblox, and Sea Ltd**) that could benefit from this shifting landscape**.**

Attractive Industry

The game entertainment industry, as a whole, has been attractive to own primarily because it sells **interactive and entertaining digital goods** with near-zero marginal costs. Billions of new gamers have come in due to new form factors, leading to new distribution and economic models. Underscoring the industry's attractiveness, game media assets command higher valuations than traditional and music media.

Incredibly, half the world's population plays games, and 1.5 billion will willingly pay to be entertained[2]. The significant tailwind in the gaming industry can largely be traced back to the introduction of new form factors, specifically smartphones, which have brought gaming to a new and broader audience. Today, there are 2.8 billion mobile gamers, many who would never have considered gaming before the ubiquity of smartphones. The key drivers here are emerging markets and a surge in 'casual' players who, already equipped with mobile devices, didn't need to invest in separate consoles or high-spec PCs.

This shift also facilitated the rise of the free-to-play (FTP) model, which revolutionised game monetisation and distribution.

Author Matthew Ball[3] points out that game assets seem to be more highly valued than traditional media assets:

> "*Microsoft also completed* ***the largest tech acquisition in history, buying not an enterprise software giant, AI pioneer, or smartphone manufacturer but Activision Blizzard****… And at $70 billion, this purchase* ***cost fully nine times what Amazon spent on a TV/film-maker such as MGM, was twice the value of streaming music leader Spotify****, and had a greater enterprise*

[2] *Source: Newzoo 2024 Global Games Market Report*
[3] *Source: https://www.matthewball.co/all/gaming2024*

value than Hollywood giants such as Warner Bros. Discovery, Paramount Global, NBCUniversal, or Lionsgate (indeed, even some of those players combined)".

Maturing Industry

But despite the favourable tailwinds of the last decades, the gaming industry is no longer the burgeoning field it once was. Industry growth rates are tempering to more sedate levels of 2% to 4%, signalling maturation and saturation.

In today's market, the abundance of games massively outnumbers the available leisure time of consumers, setting up a vigorous competition for the affections and wallets of "whales". Moreover, the industry is exhibiting early signs of trouble, with an escalating number of layoffs within gaming studios, pointing to deeper structural issues.

Our Thesis

We hypothesise that the gaming industry is undergoing economic and structural consolidation, and within this shifting foundation, we see opportunity.

Our thesis is that the industry will broadly coalesce into three buckets:

- **Bucket 1**: A select group of dominant game companies will shift from a volatile "hit-driven" model to a more stable evergreen IP "franchise" model;
- **Bucket 2**: A limited number of "winner-takes-most" UGC platforms, such as Roblox or WeChat Mini-games supported by a core user base and a long tail of user-generated content games, will engulf the tail of the 'indie market'.
- **Bucket 3**: Lastly, the rest of the market will remain entrenched in the existing competitive paradigms (title-driven and free-to-play games), striving to attract and retain gamer engagement.

In our fund, we have exposure to all three buckets: (1) franchise builders through Tencent and SEA Ltd; (2) long-tail platforms through Roblox and Tencent (once again); and, while there is a competitive match for eyeballs and dollars, we prefer (3) "picks-and-shovel" enablers like **AppLovin**, which we have spoken about in previous letters.

We will kick off our thoughts with Bucket 3, where we highlight the challenges and opportunities. Then we'll circle back to Bucket 1 & 2 – particularly how they're threaded across our portfolio.

Bucket 3: The Current Market

We start with the current state of the "hit" title-driven market. These dynamics are not new, so many studios have transitioned to free-to-play games (FTP). We then talk about AppLovin, which is at the nexus of making this traditional market successful.

User Acquisition, Pricing Power and Cost of Development in the "Hit" Market

The primary economic challenges in the traditional "hit-driven" business model are that a new audience must be acquired each time, prices are stagnant, and development costs have increased materially.

The "title" model adapts many of Hollywood's traditional marketing and financial attributes. *Studios* compete with new game stories, *genres*, and mechanics that require constant invention. Games are *released* with early "leaks" and billboard marketing to garner hype and, hopefully, pre-release sales.

Game title publishers are finding that they're unable to raise the prices of AAA games even close to inflation levels. Most of a title's economic value is generated in the first few weeks of release. After that, studios eke out back-catalogue revenues through discounted sales or micro-transactions. The challenge is that users have come to expect these eventual discounts, and 58% of PC buyers only buy when a game goes on sale[4].

Five years ago, developing a typical AAA game cost \$50-\$150m. Today, budgets for producing these titles hover around \$200m or more.

The significant upfront investment requires a high probability of success, and with a stagnant price point, the only way to justify this investment economically is to find more players who will be highly engaged and willing to pay more.

Free To Play

As these dynamics have unfolded, many game studios have pivoted to a free-to-play (FTP) model. They cast a wider net to capture a large audience with free access while banking on a minority of high-spending players—often referred to as 'whales'—to sustain the game's viability. Typically, 90% of users play for free, and only 10% are paying customers.

These 'whales' are tremendously valuable, contributing far more than the average player, but this reliance forms an inherently unstable economic foundation for these companies.

The critical challenge for these companies is identifying and attracting these 'whales' as cost-effectively as possible. In this ecosystem, intermediaries acting as "monetisation enablers" for these studios can play an indispensable role and capture some of the value they create.

AppLovin

AppLovin is one of these intermediaries strategically positioned in the middle of the Bucket 3 segment.

AppLovin has been a standout performer in our fund this quarter. In our 4Q 2023 letter, we highlighted the business, noting how it has built an exceptionally profitable AI-driven business by solving the abovementioned challenges for the game sector.

Saturated Player Time Growth

It's worth restating the problem: growth in total engagement time has plateaued. The industry's fight now is to claim a share of that time. But, what if, within this fixed engagement time, there was a scenario where gamers were discovering more relevant games, and, as a result, they might spend more money per hour of engagement – the game studios could still prosper? *An analogy would be a scenario in which every employee was matched to their perfect job. They would be more productive, and everyone would be wealthier.*

[4] *(Source: 2024 Global Games Market Report)*

SaltLight Capital Management
Unit 3 Brookwood, 50 Hyde Close,
Hyde Park, Johannesburg, 2196
Telephone: (011) 268-6057
Website: www.saltlightcapital.com

AppLovin is instrumental in this 'matchmaking' dynamic (or targeting in industry parlance). With access to 1.4 billion active mobile users, it has an unparalleled global reach. It also holds the largest market share among advertisers (primarily other game studios) seeking to acquire users.

How did they obtain this reach? The gaming advertising industry is peculiar because an advertising buyer can also be an advertising seller. In the case of FTP games, developers need to monetise their "free" users somehow by offering digital space to show ads.

So, on the one hand, they're buying ads to find 'whales'; on the other, they are selling the engagement time of their free users.

Data Creates Growth

AppLovin's position as a matchmaker is precious because it obtains unique data from both sides. This data is continually ingested to train and optimise its AI model called Axon 2. This reinforces a competitive moat: more game studios, more advertisers equals data and better targeting and –as a result - more revenue.

And by improving the targeting, AppLovin doesn't just benefit individual studios. Because of the peculiar dynamics of the industry, they have the **potential to grow the industry as a whole**.

Like our optimal jobs analogy, optimising targeting creates wealth for everyone. *Here is why: the game industry has zero marginal costs, and advertisers can be both producers and consumers of advertising.*

Digital goods inherently boast a zero marginal cost, starkly contrasting with physical goods, which invariably incur some marginal expense. In the physical world, advertisers are usually confined to a fixed media budget that needs to be allocated across TV, print and internet advertising.

As long as the revenue from an acquired user exceeds the cost of acquiring the user, the advertiser is incentivised to continue spending[5] on user acquisition. Remember that acquiring a non-payer user can also be valuable because these eyeballs can be sold as ad inventory.

The attractive selling point for advertisers who use AppLovin's platform is that they only pay when they achieve their targeted results. This performance-based model creates a win-win situation, incentivising AppLovin to improve its AI algorithms to ensure better incremental targeting. We elaborated on the source of effectiveness in our 4Q23 letter, praising its ability to leverage contextual data for ad matching.

Could App Advertising Work with E-Commerce?

In the last two quarters, AppLovin management has hinted that the Axon 2 AI model could also be applied to performance-based e-commerce advertising. If this pans out, the e-commerce market will be orders of magnitude larger than the game sector. For advertisers, AppLovin would be a welcome addition to the cosy online advertising duopoly of Google and Meta Platforms.

[5] Advertisers work on a metric called Return on Ad Spend (RoAS) which is the return within a time period. Of course, they would also have some cost of capital in the return hurdle too.

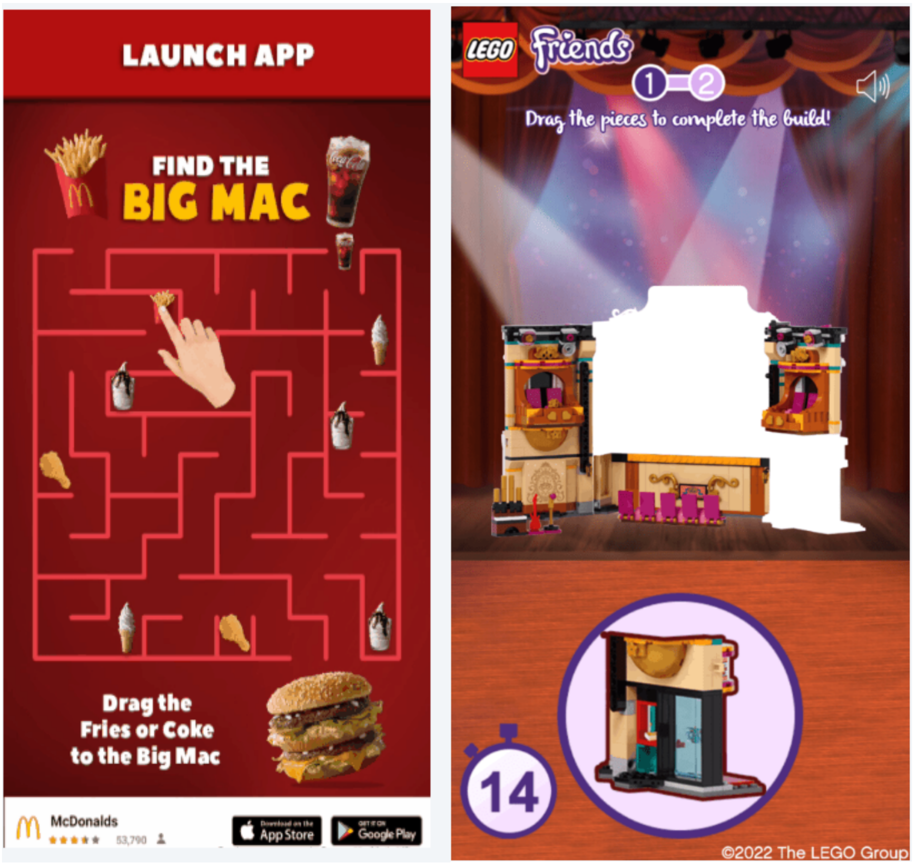
We don't know how the economics will work with e-commerce advertisers. For one, advertisers will now sell a physical good with marginal costs.

We suspect that the most attractive feature for advertisers who use performance-based marketing is that a new supply of ad inventory (new eyeballs) will mean lower advertising costs.

With users spending substantial time in mobile apps—averaging nine apps and four hours per day[6]—there's a vast, underutilised audience not fully reached by traditional platforms like Google Search or Meta's social media.

In-app advertisements offer unique engagement opportunities. They occupy the whole device screen without competing content - commanding user attention. Interactive ad formats, such as videos (called playables in the industry), introduce user participation—like jumping over obstacles or navigating a vehicle—which can be particularly engaging.

Extending this interactivity to e-commerce, users could, for instance, scroll through clothing items within an app, seamlessly blending shopping experiences into their daily app usage.



This potential expansion offers AppLovin a new opportunity vector and promises advertisers a more diverse and cost-effective platform for reaching consumers.

[6] *Source: Consumer Mobile Trend Report 2024 link*

We'll see how this unfolds over time.

Bucket 1: Evergreen Gaming Offers More Predictable Revenues

Circling back to bucket 1: evergreen gaming. In the evergreen IP franchise model, the developer brings adaption and innovation within an existing core franchise with a sizeable engaged user base rather than inventing a new game story or mechanics.

The economic calculus shifts from acquiring users to retaining them. Within the context of saturated engagement time, these evergreen games are sapping eyeballs away from newer games trying to break in.

We are particularly delighted with this model, as revenues inherently become more predictable and project risks reduced. The economics are also favourable for free cash flow: players pay upfront to receive the virtual good (which has a zero marginal cost). Beyond engineering costs, this is high-margin revenue.

Let's take a look at two in our portfolio, Tencent and SEA Ltd, to see how they do this:

Tencent is the global leader in the arena of franchise games. Today, it has eight franchise games earning over US$500m in gross receipts annually[7]. China is, perhaps, one of the most competitive game markets, and many lessons are being conveyed to Western markets. Some of Tencent's older games are half a decade old, yet millions of daily active players are still playing. Tencent is also getting very good at creating new evergreen games.

How do they elongate a game's franchise?

- Social mechanics are introduced that allow players to interact, compete, and collaborate, driving network effects and lowering acquisition costs.
- Content is frequently upgraded with new characters, maps or game modes to keep the game fresh.
- Time-limited events are introduced to coincide with holidays or special occasions.
- An in-game economy encouraging player investment without exploitation.
- Lastly, many games are integrated with e-sports, where professional game teams play at events that bring like-minded gamers into a physical space.

SEA Ltd, which is focused on Southeast Asia, has the wildly successful Free Fire game franchise, first launched in 2017.

Free Fire has an astounding 648 million quarterly active users and 53 million paying players, spending an average of $42 a year[8]. The company's large user base is due to its game design being playable on lower-spec phones, which are more prevalent in emerging markets. Nevertheless, the business makes good money overall. Over the last twelve months, SEA Ltd made $1bn EBITDA with 50% margins. This is a phenomenal business that doesn't require much capex to grow.

Our view is that the market has underappreciated the annuity-like nature of these evergreen game franchise businesses. Tencent, in particular, is valued at a multiple that doesn't appreciate the nature of the game business.

[7] *Source: Tencent 2023 Annual Report*
[8] *3Q24 Company Results*

SaltLight Capital Management
Unit 3 Brookwood, 50 Hyde Close,
Hyde Park, Johannesburg, 2196
Telephone: (011) 268-6057
Website: www.saltlightcapital.com

Bucket 2: User-generated Content Platforms

Our last bucket is likely to see formidable growth in the coming years. Given the industry trends we've discussed—limited engagement time and increasingly difficult game industry economics—user-generated content platforms (where games are developed by micro studios, semi-professionals, and hobbyist creators) open up a new dimension of gameplay.

This evolution is strikingly reminiscent of YouTube's ascent. The platform began with amateur videos—often simple clips of cats—but as it became the central hub for video content, it attracted professional creators seeking the largest audience. The aggregation of both content and viewers created a virtuous cycle that reinforced YouTube's dominance.

Similarly, we're witnessing a long tail of hobbyist-created games in the gaming industry. While many of these games cater to niche interests, a few breakout hits rise to the top, propelled by innovative game dynamics and the sheer accessibility of the platforms. This diversifies the types of games available and disrupts traditional distribution and monetisation models.

Roblox has firmly established itself as the dominant player in user-generated gaming within Western markets. Meanwhile, **Tencent** has developed a similar ecosystem in China with its WeChat Mini-games platform. Owning both gives us a unique vantage point to assess the evolving landscape of user-generated gaming platforms globally.

At its recent investor day, Roblox set an ambitious target of reaching 10% of gaming content revenue, of which it estimates the total pool is around $180bn (for context, in the last twelve months, it made $4bn in bookings).

We think this will be a challenging target, but it will be positive for the business directionally. The reason is that Roblox has spent the last three years heavily investing in re-engineering its game platform to be high fidelity, performant and widely available across platforms. They also share economics with their creators to the point now that the absolute numbers in highly engaged games are enough to support a small game studio. The result is that the quality of games has materially improved, attracting additional engagement – particularly from older users.

For game developers, Roblox presents an increasingly attractive platform. Developers gain instant access to 79 million daily active users (4x that in quarterly active users). More importantly, their games become immediately accessible across iOS, Android, game consoles, PC, and VR without developing separate versions for each platform.

This cross-platform accessibility dramatically shifts studio economics. Developers can avoid the costs of hiring infrastructure specialists or platform-specific engineers and sidestep common support issues on various devices. For example, content creators upload videos to YouTube without worrying about distribution logistics, and developers can focus solely on creating engaging games while Roblox handles the rest.

This platform architecture has drawbacks. Roblox needs to continuously spend money to make its platform safe for its younger audience, upgrade its infrastructure, and improve its game engine. It also pays a significant portion of every dollar to the app platforms (Apple and Google).

SaltLight Capital Management
Unit 3 Brookwood, 50 Hyde Close,
Hyde Park, Johannesburg, 2196
Telephone: (011) 268-6057
Website: www.saltlightcapital.com

The next opportunity for Roblox is to monetise its vast user base with advertising. We expect this will be an increasingly important part of the investment thesis over the next few quarters to show that Roblox can generate the types of returns on capital that we think it can.

For Roblox, the future growth in this segment isn't just about more games—it's about a fundamental shift in how games are created, distributed, and experienced. User-generated content platforms are not just a new bucket but a transformative force reshaping the gaming landscape.

******

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

"*Collective investment schemes are generally medium to long-term investments. The value of participatory interest (units) or the investment may go down and up. Past performance is not necessarily a guide to future performance. Collective investment schemes are traded at ruling prices and can engage in borrowing and scrip lending. A schedule of fees, charges, minimum fees, and maximum commissions, as well as a detailed description of how performance fees are calculated and applied, is available on request from FundRock Management Company (RF) (Pty) Ltd ("Manager"). The Manager does not guarantee the capital or the portfolio's return. The Manager may close the portfolio to new investors to manage it efficiently according to its mandate. The Manager ensures fair treatment of investors by not offering preferential fees or liquidity terms to any investor within the same strategy. The Manager is registered and approved by the Financial Sector Conduct Authority under CISCA. The Manager retains full legal responsibility for the portfolio. FirstRand Bank Limited is the appointed trustee. SaltLight Capital Management (Pty) Ltd, FSP No. 48286, is authorised under the Financial Advisory and Intermediary Services Act 37 of 2002 to render investment management services.*"