BAOBAB
INVESTMENT MANAGEMENT
AFRICAN ROOTS | GLOBAL PERSPECTIVE

Annual Partners Report

The Purpose of our Annual Partners Report

The primary objective of this report is to provide more expansive commentary on our investment philosophy and process that drives the selection of the companies we own. By providing you with greater information about how we think and act, and the companies we own, you are more likely to understand and have confidence in the drivers of future returns. Very importantly, our partners will have greater understanding when we undergo periods of poor short-term performance which are inevitable.

We apply the same approach to all of our portfolios, both locally and abroad, but the majority of this letter will be devoted to our Global holdings. Not only is this core to our offering, but owning global equities in preference to domestic rand hedge counters is a key differentiator of our local offering as well.

A partnership

A core principle of Baobab Investment Management is that we view our business as a partnership. We view our clients as partners and invest in the same portfolio of companies together, ensuring that our interests are well aligned and we are all in the same boat. While I may be the skipper of the boat, I am paying the same fees to travel, have the same destination in mind and experience the same conditions at sea.

Our mission at Baobab is a simple one – to produce the right long-term returns for the right group of people. If we achieve these two objectives, we will have a successful and authentic Investment Partnership.

Patience, selectivity and cash

Patience is a cornerstone of our investment approach, both in terms of having a long-term focus, as well as being patient in waiting for the right investment opportunities to present themselves. A question we always ask ourselves before a new purchase is "Are we buying on our own terms?" If the answer is no, we will pass. Unlike many managers of equity portfolios, we do not view our job as giving clients exposure to the market. Our job is to provide the right returns. If we cannot find enough companies that meet our criteria for investment, we will hold cash until we do. In strongly rising markets this will cost us as we will miss out on some of the gains, but through a full market cycle it can add a lot of value.

In a recent speech at the Harvard Business School, world renowned value investor Seth Klarman commented that

"ONE OF SOCIETY'S MOST VEXING PROBLEMS IS THE RELENTLESSLY SHORT-TERM ORIENTATION THAT MANIFESTS ITSELF IN INVESTING, IN BUSINESS DECISION-MAKING, AND IN OUR POLITICS. "

Thinking long-term is becoming more and more difficult in the modern age. As challenging as it may be, I think the rewards are significant for those who are prepared to do so, in investing, business and in life. At Baobab we will continue to work hard to become even more long-term orientated as we know what a significant advantage this is over most modern investors that are obsessed with what might happen next month or next quarter. We will also continue to seek out companies to invest in where management have a similar, long-term outlook and are prepared to sacrifice short-term gains in pursuit of the right long-term shareholder returns.

Return profile and performance overview

Our core investment objective is to provide above average returns at below average levels of risk. Based on our experience and investment approach we would expect to achieve this by producing average returns when markets are rising strongly, but to do much better than average when markets are tough. Our prudent culture and philosophy may prove a headwind when excessive risk taking is rewarded, but when the going gets tough, our risk-conscious approach usually provides some form of preservation. In short, we are prepared to miss out on some of the upside to help contain the downside. In the past 3 years our return profile has by and large played out this way.

The South African market has been very tough and we have been much better than average, largely because we managed to avoid most of the widely held shares that came unstuck. Investing directly offshore as opposed to holding expensive rand hedge shares such as Aspen, Steinhoff, British American Tobacco, Mediclinic, Richemont and AB Inbev was a key contributor to our domestic portfolios doing so well.

Annualised returns to 31 December 2018		
	1 year	**3 years**
Baobab Domestic Portfolio	**-0.88%**	**8.36%**
Average general equity fund	-9.23%	1.82%
JSE Allshare Index Total Return	-8.53%	4.33%

Our global portfolio returns have been solid and have delivered on their objective during this period, but it has been a much tougher environment for value-conscious investors. The market has been dominated by large cap US growth stocks (Amazon, Google, Netflix, Mastercard etc) that we have had no exposure to. Most of these are great companies, but at current levels we are certainly not "buying them on our terms". Our long-term absolute return target for global portfolios is 6% in USD net of all fees and we are pleased to have delivered on that over the past 3 years.

Annualised returns to 31 December 2018		
	1 year	**3 years**
Baobab Global Portfolio	**-6.58%**	**7.92%**
Average Global Equity Fund	-11.20%	4.10%
MSCI World Index	-8.80%	7.10%

Portfolio commentary

Domestic portfolios

We sold out of 4 positions in local portfolios during 2018. Anglo-American, Imperial and Store-Age were all sold at very healthy profits. Anglos is worthy of further commentary as it is a good example of both the strengths and weaknesses of our investment approach. We bought Anglo American in late 2015 and early 2016 when concerns around China led to panic selling across the commodity complex. While analysts were adjusting their excel models to weakening commodity prices and downgrading their estimates, our focus was on the durability of their asset base, with De Beers in particular providing a solid underpin to our valuation. While it may seem easy with the benefit of hindsight, I can assure you that buying our last Anglos shares at R56 in January 2016 was anything but easy and required a very strong stomach. We have gradually sold our shares in Anglos, and in February last year we sold our last shares at R272. As much as having the temperament to buy amidst panic is a strength of ours, selling too early is a weakness and Anglos has strengthened further since our sale. While we continue to work on our investment process to try and become better sellers, in the case of Anglos we have no regrets as we do not view it as a high quality company that we would like to own for 10 years or more. While we have no idea what the growth rate of China might be going forward, we are wary of some of the risks inherent in the country that may one day come to bear. Given that China is such a key purchaser of commodities, we were happy to take some money off the table and reinvest elsewhere. After the sale of Anglos our only direct commodity exposure is to Impala Platinum and Anglogold, both of which we added to during 2018 at very depressed prices.

Our other domestic sale was anything but a success. We pride ourselves on limiting mistakes, which are inevitable in investing, but Group 5 was a mistake which we sold at a significant loss during the first half of 2018. While the position size was small enough to limit the damage, we have nevertheless thought deeply about what went wrong and what we can do to avoid similar mistakes in the future. Without going into detail, we will certainly focus more on contract risk in the future, but perhaps of greater significance is the increased weight we are now placing on the importance of an aligned management team. Had Group 5 been owner managed, it is very unlikely that they would have walked away from the offers they received for their high quality Investment and Concessions business. We focused too much on the value of this division and not enough on the risks elsewhere and the misalignment of interests. Some harsh lessons learned that I am confident have resulted in some improvements to our investment process going forward.

The bulk of buying during 2018 was adding to existing names, with a few new offshore names included that are covered below.

Global portfolios

During 2018 we sold our entire positions in Discovery Communications, Samsung Electronics and Qualcomm. Qualcomm was sold at a small profit as the investment case became less clear to us and we switched into companies where our conviction was higher. We nearly doubled our money in Discovery Communications and Samsung as both were purchased at very attractive prices. Both are good companies, but neither is exceptional, hence our decision to sell when they reached a level somewhere near our estimate of fair value. Again, the proceeds were channelled into new ideas of higher quality.

Of greater significance are the new positions we established during the year, all at what we think are very attractive prices. Brookfield Asset Management, Oaktree Capital and Liberty Broadband are all high quality companies with exceptional management that we think provide a very attractive risk/reward profile. Some of our other purchases may not be of the same quality, but their valuations provide significant asymmetry (strong upside with limited downside) in our view.

Company commentary

Global holdings

21st Century Fox
Our thesis that great content will always have value played out during 2018 as Disney won a bidding war for the bulk of the film, TV and media assets of Fox. The deal led to a sharp appreciation in the price of 21st Century Fox and it is likely that we will end up with a mix of cash, Disney shares and shares in the new Fox that houses Fox News and their other US TV networks. We think the new Disney will be a very powerful company, but given some of the competitive issues we have higher conviction elsewhere and thus our preference is for a greater portion in cash.

Fiat Chrysler and Exor
We were deeply saddened by the passing of Fiat Chrysler CEO Sergio Marchionne in 2018 as he was a leader we admired and learned from. He has also delivered outstanding returns to us as Fiat shareholders in the past few years, including the value accretive spinning off of Ferrari. We own Fiat both directly and via holding company Exor, where we get exposure to other very good assets such as Ferrari and global reinsurance company Partner Re. Fiat and Exor have given up some of the strong gains of 2017, but have continued to make operational progress during the year. Some key highlights include the sale of their parts division, Magnetti Marelli, and continued growth of the Jeep and RAM brands, placing Fiat in a very strong position in a very challenging environment for global automakers. The decision to largely exit the sedan market and focus on SUV's has paid huge dividends, with the Jeep brand showing particularly strong growth. From 337,000 vehicles sold in 2009 Jeep's expected sales for 2018 is close to 2 million vehicles.

We have been asked, and have asked ourselves many times, with global growth and automobile sales seemingly under pressure, why on earth would you want to own such a cyclical company? The answer is that even after strong returns in recent years, Fiat remains too cheap in our view. It still trades at a low single digit earnings multiple, despite the fact that margins have improved significantly, and it will soon be in a very strong net cash position. In addition to this there are multiple ways for management to extract further value from their strong portfolio of brands (Jeep, RAM, Maserati, Alfa Romeo) and some consolidation in the industry could dramatically improve returns as well as company ratings. We are not holding out for corporate action, but we are comfortable that we are co-owners with John Elkann and Exor and that our interests will be well looked after.

Fairfax India
Fairfax India also gave back some of its strong gains of 2017 as Indian equities retreated along with other emerging market equities. We took advantage of this weakness where appropriate to add to existing positions as we think the long-term opportunity remains excellent. Fairfax India already owns some very good assets and with exceptional management we have high confidence that significant value will be realised for patient investors. The two key assets are IIFL Holdings Limited ("IIFL") and Bangalore International Airport Limited ("BIAL"). IIFL is a publicly traded, diversified financial services holding company located in Mumbai while BIAL is a private company located in Bengaluru, that has the rights to develop, maintain and manage the airport and sizable area of land around the airport. As much as we like the assets and long-term opportunity in India, having a world class capital allocator like Prem Watsa at the helm is what gives us conviction. Book value has declined together with Indian equity valuations in 2018, providing a good entry point to buy a high quality of Indian assets at or near 1 times book value.

Liberty Broadband
Liberty Broadband was a new addition to portfolios in 2018 and is a holding company for Charter Communications – ie we are owners of Charter Communications but at a discount. Charter is the second

largest cable company in the United States offering television, internet and telephone services via a large, installed cable infrastructure. While the market views Charter as a cable company, we view it as a connectivity company that can offer homes and businesses exceptionally fast internet, a service that is likely to remain in high demand and which is non-cyclical in nature. The company has been in investment and integration mode in recent years and continues to expand its customer base within the areas covered by their cable infrastructure. We expect the very good cash flows and economics of their broadband offering to start delivering in 2019 and beyond. In short, we are part owners of a unique asset in the hands of exceptional management who are large co-owners of the business and whom have a long-track record of adding shareholder value. They have already been offered significantly more than the current price to buy the business, but have thus far resisted given their confidence in the future cash flow generation of the company.

Brookfield Asset Management

Brookfield is another new ownership stake of 2018 and is typical of how our investment process works. We have followed Brookfield for a couple of years and have enormous admiration for the CEO, Bruce Flatt, and the value investing principles that he applies to the management of alternative asset classes such as real estate, private equity, renewable energy and infrastructure. Despite loving the company, we could never build conviction in the valuation until late in 2018 when we first started purchasing the shares. To be honest, we were greatly assisted by Brookfield themselves as they have been very transparent in telling investors how they value the company. We always knew we wanted to partner with the management team, thus needed to do further work on the valuation as well as gain greater understanding of the growth runway for their business. Upon further analysis we came to the conclusion that the opportunity in the alternative assets space is enormous and that Brookfield is very well placed to benefit from this. At an Investor Day in September Brookfield laid out some of their long-term (10 years) expectations which included potential cash flow generation from asset management fees and their various investment activities. The powerful cash flow generation of the business makes for a very compelling investment case, but is supplemented by the knowledge that the cash will end up in the hands of an exceptional management team with an outstanding long-term track record.

Lindblad Expeditions

Even though it retraced some of its gains late in the year, Lindblad appreciated strongly (38%) during 2018 as the company started to deliver on its long-term potential. Lindblad is a niche company offering a high quality and authentic product within the travel industry. While the expedition travel industry will no doubt go through its ups and downs we think a purpose-driven company like this will see continued demand for a product of high quality, supported by its association with National Geographic. As the company slowly uses cash flows from the business to add capacity via a couple of new ships, we think that earnings will be significantly higher in 3-5 years time and that this will ultimately reward us as shareholders. The investment case is supported by a founder CEO who is the largest shareholder, is purpose-driven and of high integrity, someone we are happy to share a boat with!

Oaktree Capital

Oaktree is another new position that we bought into weakness in 2018. Like Brookfield we have followed Oaktree for many years given our admiration for the Chairman Howard Marks, one of the world's most respected investors. As an asset manager with a specific focus in credit, earnings can be lumpy as levels of performance fees fluctuate, but with the shares trading at or near 5 year lows and a 7-8% dividend yield we view them as attractive. We also like the defensive and counter-cyclical element of an investment in Oaktree. As risk-averse value investors they tend to increase cash weightings as credit markets become more expensive, thus have significant dry powder when markets dislocate. They also have a sufficiently strong reputation and track record to raise new capital when markets are weak and the opportunity set increases.

Weiss Korea Opportunity Fund
The opportunity in Korean preference shares is not dissimilar to the one we see in South African small and mid-cap companies. Outside of Samsung which is well known and followed by emerging market investors, there is no Amazon, Naspers or Netflix in Korea to get excited about. What there is though is a very cheap market with many sound companies that creates a very compelling long-term investment opportunity. While the broad index in South Korea is itself cheap (PE ratio of 10), most preference shares trade at 40% discounts or more, even though they have the same economic interests as the ordinary shareholders. We expect that over the next 5 years corporate governance in Korea will improve and this discount will narrow. Together with some growth in earnings and a very low starting valuation, this makes Weiss Korea a relatively low risk investment, with significant upside should our thesis play out.

Rolls Royce
The share price of Rolls Royce rallied strongly into the middle of the year as the Company started to deliver on some of the operational improvements under new CEO Warren East. Unfortunately, these gains dissipated in the last few months of 2018, something that wasn't uncommon for UK listed companies. As the largest manufacturer of engines for widebody aeroplanes, we think that Rolls Royce remains well placed to benefit from the structural growth in air travel. While the business and contracts with customers have complexity that can lead to some lumpiness in cash flows, as the fleet grows and the business becomes leaner, we expect the recurring cash flows from their care and maintenance contracts to grow significantly. One of the qualitative questions we ask when assessing the quality of a company is how easy is it to replicate. Could a new entrant with a large cheque book enter the market and compete? In the case of Rolls Royce the answer is a definitive no in our view. Airbus may change the supplier of their carpets, but the decades of expertise and intellectual property associated with designing a fuel-efficient engine means they are unlikely to ask a new entrant to design an engine for them. The risk associated with failure is just too high. A lack of focus has seen the company stray from its core strengths in the past, but we are encouraged by the renewed focus under new leadership.

Domestic holdings

We have not made any significant new domestic purchases during 2018 and have largely been adding to existing positions during bouts of weakness. We continue to take advantage of our small size to invest selectively in the small and mid-cap sector of the market which we view as particularly attractive. Even after suffering large losses through holding large companies like Steinhoff, Aspen, Woolworths, British American Tobacco etc, most local investors deem all small companies as risky, regardless of their business model, balance sheet or the management team. Therein lies the opportunity for those prepared to do their homework and find low-risk opportunity in this unloved area of the market.

Bowler Metcalf
Late in the year niche packaging company Bowler Metcalf paid out a special dividend of R3, being some of the proceeds from the sale of their non-core beverage business. Bowler started the year trading at about our average purchase price (R7.50), paid total dividends of nearly R3.50 and ended the year slightly higher than where it started, resulting in a nearly 50% total return in 2018. After the distribution Bowler retains excess cash on its balance sheet and the remaining packaging business is still very cheap, even on current earnings in a depressed economy. I have highlighted Bowler as it would be viewed by most in the industry as a risky investment largely because of its size. Bowler is by no means an outstanding business, but because we bought it at the right price, supported by cash and other realisable assets, it has proved to be a safe investment in a very tough environment. The fact that it is small and illiquid does not add to the risk, but possibly was a key factor in allowing us to buy it at a very good price. We think Bowler Metcalf serves as a very good proxy for the opportunity set that we see in the small and mid-cap part of the local market where you can buy decent businesses with honest and capable management teams that are themselves significant owners. Regardless of the outlook for the domestic economy, the shares are cheap enough to provide significant margin of safety at current levels.

RECM and Calibre

RECM and Calibre is also small (R850 million market cap) and fairly illiquid, yet we think it offers a very compelling risk/reward set up for patient investors. Management is a critical factor when investing in an investment trust vehicle such as RECM and Calibre. Our simple view of the management team (Piet Viljoen and Jan van Niekerk), is that as fellow value investors we are happy to partner with them because we think that they are honest, and we know that they do not like overpaying for assets. They will make mistakes and bad investments, but they are very unlikely to overpay for assets at the top of the cycle. Paying too much for seemingly good assets has been the downfall of a large number of local companies in recent years. During the year RECM acquired a stake in a listed offshore investment vehicle, Astoria. Astoria is managed by Anchor Capital, has consistently traded at a significant discount to asset value and is now the second largest holding in the RECM and Calibre portfolio. Having made an earlier offer to Astoria minorities, it seems as if the discount in Astoria will be taken care of in the first quarter of 2019, with management announcing that they will be selling assets and distributing cash to shareholders. While the narrowing of the discount should provide an immediate boost to the NAV of RECM and Calibre, the cash injection would be very welcome. As shareholders we would be surprised and disappointed if they do not use some of the proceeds to buy back their own shares at what we think are very undervalued levels. Again, we do not have a detailed excel model on RECM and Calibre, but at current prices think it offers high potential return at a very low level of risk.

Outlook

We acknowledge that we live in complex times of rapid change and face many unprecedented economic and political challenges, not least of which are the excessive debt levels that have supported this global recovery. Amidst this backdrop we continue to embrace simplicity in all that we do and seek investments that are simple and safe. A portfolio of good companies run by honest and capable management teams and purchased at the right price, should be able to withstand even the toughest of macro environments.

This is why we do not spend too much time trying to make forecasts about economies, politics or other macro factors. As interesting as analysing these issues via daily newsflow and data may be, it provides very little benefit in terms of long-term wealth creation. Many people correctly predicted that domestic politics will prove a headwind to economic growth and the local currency. The problem was that armed with this analysis, they chose to invest in what turned out to be very expensive rand hedge shares and actually lost money. They got the economic analysis right, but the stock analysis wrong. We prefer to focus on the stock analysis, using our tempered view of the macro-environment as a framework to help us manage the risk of individual positions.

The one forecast I can make is that most investors will continue to be driven by sentiment and apply short-term thinking, thereby creating opportunity for those who are willing to invest against the prevailing sentiment and make decisions based on the long-term. To enable us to do that we need partners that allow us to stand apart from the crowd in the short-term in our shared pursuit of long-term gains. For this we thank you and will continue to work hard to earn and maintain your trust and make sound investments on your behalf.

All the best for a healthy and happy 2019.

Kind regards

Sandy Le Roux

Note: The performance figures quoted are for a fully discretionary managed client and are net of fees. For domestic portfolios, asset swap is used for the offshore holdings. Because we construct each portfolio individually based on the opportunities available in the market, there will be some variation in returns across our accounts, particularly for newer accounts and those where we have inherited positions. While this can make communication about our portfolio difficult in the short-term, we believe that building portfolios in a bespoke and considered manner is in the best interests of our clients and a key differentiator of our offering.

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