DESERT LION

— CAPITAL —

February 2022

DESERT LION CAPITAL FUND I, LP
Q4 REPORT FOR THE PERIOD ENDED DECEMBER 31, 2021

Dear partners and friends,

Desert Lion returned +7.2% net for Q4 2021, bringing the total net return for 2021 to +9.6%.

The top three contributors to our 2021 performance were Argent (+100% YOY), Capitec (+42% YOY), and Stadio (+92% YOY). The top detractors were Sibanye Stillwater (-17% below our average purchase price), Naspers (-9% below our average purchase price), and the USD/ZAR exchange rate (-8% on total portfolio in USD). This letter contains current summaries of the competitive positioning of each and my theses on the drivers going forward.

I am optimistic on the outlook for 2022. As discussed further below, the stock price headwinds experienced by two of our larger 2021 detractors, Sibanye Stillwater and Naspers, are likely to turn into tailwinds this year. While the companies are as good or better than they were at the time of our investment, their prices are materially cheaper, implying more opportunity for upside and less risk for downside. I am also excited by the prospects of our 2021 winners, each of which enjoys structural tailwinds in addition to strong fundamentals and a compelling outlook.

The ZAR ended the year on a weak note at 15.93 to the USD. Based on purchasing power parity, the ZAR is currently undervalued against the USD. South African inflation printed 5.9% for December, compared to U.S. inflation of 7%. The South African Reserve Bank has been much more conservative in monetary expansion compared to developed markets. M2 expansion is way below U.S. M2 expansion, and South African interest rates have already been hiked twice with +25bps each during November 2021 and January 2022. Fundamentally, I believe the ZAR weakness (relative to the USD) is overdone and there is a meaningful probability that currency moves could be supportive for 2022 performance.

The Fund is fully invested with a portfolio of 12 companies, the top 5 of which constituted 76% of assets at year-end. The concentrated nature of our portfolio can lead to higher volatility, yet we consider our investments less risky based on our rigorous adherence to margins of safety and zero leverage. For most capital allocators, Desert Lion's investments can provide diversifying exposures and uncorrelated returns, often "zigging" while other areas "zag." As various industries and financial instruments hit inflection points, diversification and exposure to off the beaten path value can become even more compelling.

The great rotation?

Are we entering, or already in the early stages of, the great rotation? What does that mean for Desert Lion?

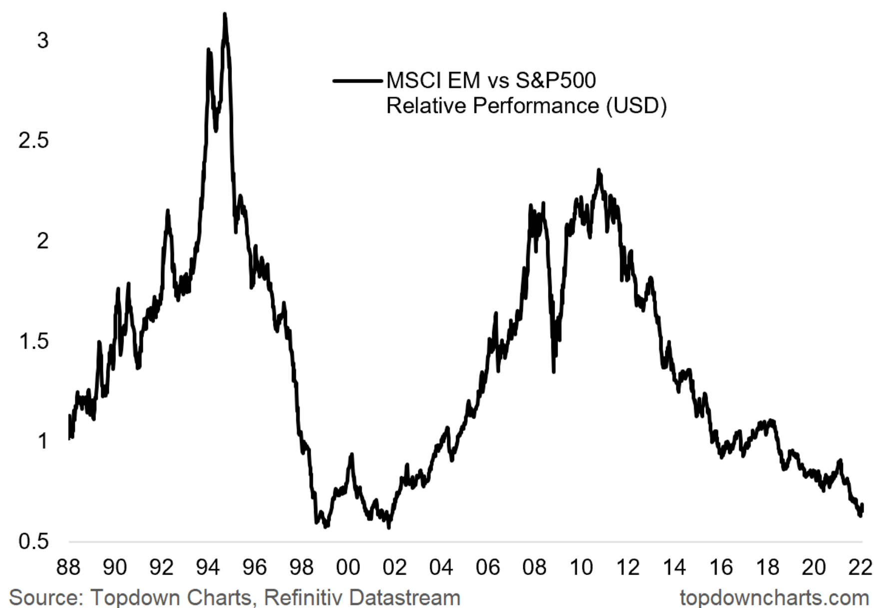
I believe it is highly probable that we will witness the following themes during the next few years:

1. Liquidity flowing from speculatively expensive to fundamentally cheap

The response to the global COVID pandemic entailed massive monetary expansion, direct stimulus transfers, and very low to negative real interest rates. Trends including the gamification of trading, record levels of retail participation in markets, momentum in growth and theme (or meme) stocks, social media-fueled crypto and NFT FOMO, TINA (there is no alternative), belief in the FED put, and indefinite extrapolation of recent returns without regard to intrinsic value, to name a few, sucked liquidity from other parts and hose-piped it into extreme, speculative excesses. It works while it works. But when sentiment changes and liquidity is extracted from the system, such "securities" often crash rapidly as the intrinsic underpinnings, if any, are very far below. That is when sanity prevails and rational capital returns to opportunities that are fundamentally attractive, offering a reasonable return on investment with a decent margin of safety.

2. The return of emerging markets

Markets move in cycles. The chart below displays the performance of the MSCI Emerging Market index relative to that of the S&P 500 over the past several decades. As we have seen in the past, there will come a time when capital rotates out of popular markets and excessive valuations back into value and previously neglected markets. That time might very well be nigh. I am quite excited to see what happens when capital and liquidity starts to recognize the opportunities we are sitting on.



3. Higher interest rates and/or higher inflation

It is becoming clear that inflation is not as "transitory" as developed market central bankers propagated. Extremely accommodative monetary and fiscal policies, combined with major disruptions to the supply chain and production, have led to widespread price increases. The problem is that most economies are overindebted and are unable to stomach the necessary

interest rate hikes without falling into recession. Therefore, the only remaining option is to keep interest rates artificially low and inflate the debt away.

4. Commodity bull cycle

As displayed in the below chart, the commodity cycle seems to be bottoming out after a structural decline since its 2008 peak. Improved capital discipline following the excesses of the previous boom, ESG investment mandates, regulatory restrictions, nationalization of resources by some governments, etc., have led to an underinvestment in new capacity. New supply takes many years to come online. Overlay unprecedented money printing, and it is quite plausible that commodities are positioned for a prolonged period of repricing.

5. Pressure on the USD

The U.S. is in the very fortunate position of having the world's reserve currency. This is a position it earned and deserves, but with that privilege comes a burden – protect the currency's value or the world's faith in the currency erodes. There are no easy choices when it comes to the USD. Interest rates are at historic lows. Real rates are negative. To attract more investment into U.S. bonds, rates must be higher, but higher rates will put pressure on the affordability of debt service costs for the U.S. government. One way to deal with the debt is to inflate it away by keeping interest rates low. But do that, and the value of the currency gradually deteriorates. It is unlikely that the U.S. Federal Reserve will raise rates on par with the inflationary regime we are facing. Therefore, it is probable that the USD will be under pressure and lose value gradually, but only relative to alternatives that did not expand at the same tempo… which again brings us back to some emerging markets, value stocks and certain commodities.

Portfolio: Top holdings

❖ **Sibanye Stillwater (JSE: SSW)**

Sibanye Stillwater is one of the largest PGM (platinum group metal) producers in the world with major operations in South Africa and the U.S. On top of its additional gold mining operations in SA, the business has significant upside optionality in its growing lithium, nickel, and uranium activities, which are not yet contributing to earnings and remain unrecognized by the market in SSW's price.

As discussed in the previous quarterly letter, the company reported record earnings for the interim period ended June 2021. TTM EPS was R12.03, placing the stock on a PE multiple of 5. Cash generation is excellent and the company is effectively debt free with surplus net cash. The management team continues to stay disciplined in their capital allocation, using cash profits to settle debt, repurchase 5% of the company's shares at a discount, pay a healthy dividend (~11% annualized dividend yield), and expand their battery metals strategy with lithium and nickel acquisitions.

During 2021, PGM prices were down from their highs on the back of chip shortages and auto manufacturing concerns. I believe these demand shocks to be transient. PGM prices have already rebounded going into 2022, and the long-term outlook remains buoyant. There is much pent-up demand for vehicles and, combined with increasing inflationary expectations, auto manufacturing will likely overshoot once chip shortages are resolved. While climate change is becoming an increasingly prominent theme globally, I believe internal combustion engines are going to be around for longer than most expect. Battery electric vehicles (BEVs) require huge amounts of lithium, copper, nickel, and cobalt, and there is simply not enough of the stuff around to support the projected ramp-up in BEV production. PGMs are key to cleaner energy, and demand for some of the PGMs will continue to outstrip supply as limited capex has been allocated towards increased production in recent years. So, it will take some time for production to react to higher prices.

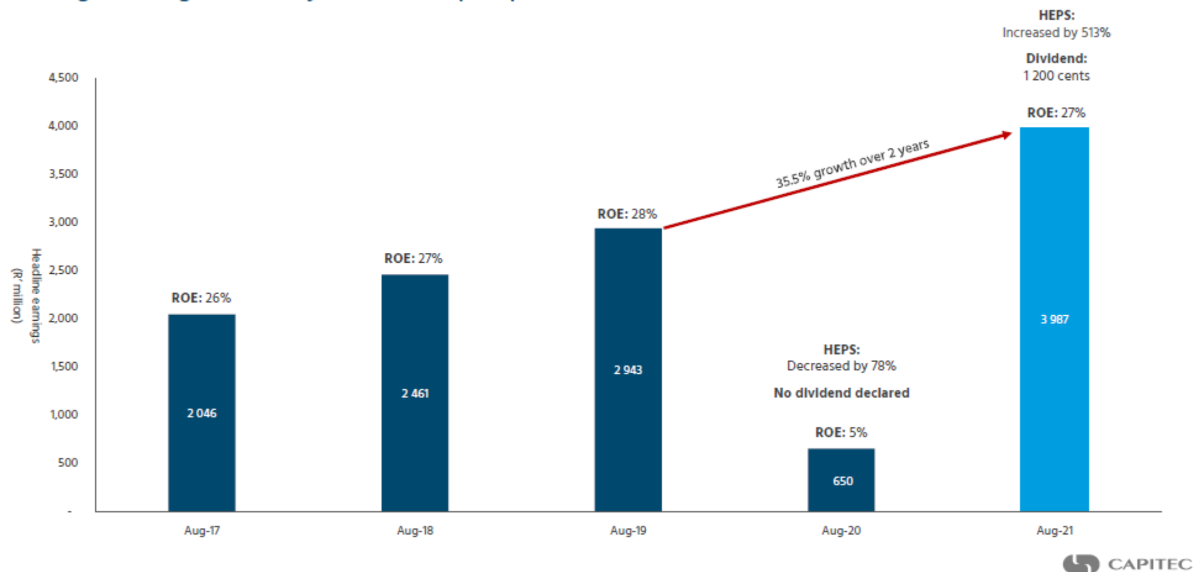
Russia produces roughly 40% of the world's palladium. The current Russian-Ukraine tensions and risks of sanctions provide further support to the outlook of palladium, which has been in production-demand deficit for some years. While substitution will take place between palladium and platinum in catalytic converters over time, the inability to substitute the minor metals – the most important of which is rhodium – makes it very likely that the PGM basket price will remain robust for several more years.

To summarize, Sibanye Stillwater is a well-managed, profitable business with excellent capital allocation discipline. I view it as a dividend-paying call option on the normalization of auto manufacturing, climate change initiatives, an underestimation of the relevance of internal combustion engines, and inflation. The company's lithium, nickel, and uranium activities also position them to participate in the continued drive towards cleaner energy, and so far, these options are not priced in at all.

❖ **Capitec (JSE: CPI)**

Capitec is the fastest growing bank in South Africa and a disruptive fintech player. We originally acquired Capitec at a discount via its former holding company, PSG Group, before the asset was spun out. For a detailed write-up of Capitec, see our Q3 2020 letter.

We have been pleased to see Capitec back on its pre-COVID growth trajectory.



Capitec's growth is not predicated on high-risk loans and instead is coming from market share gains, digital adoption, transaction fee income, and expanded product offerings. Already South Africa's leading digital bank, Capitec is also benefiting from positive operating leverage as increasing digital adoption allows the business to scale with low input costs. While some still erroneously view Capitec as a pure-play subprime credit provider, it transitioned to a fully-fledged bank and fintech player quite a few years ago. Net transaction and funeral plan income (popular in SA) now cover about 100% of operating expenses, and most of the new credit is extended to middle- and higher-income groups with better credit ratings.

With a loan-to-deposit ratio of 61%, the business does not depend on wholesale funding. Its credit loss ratio is at about 5%, while the 6% net interest margin makes competitors green with envy. Capitec's 37% capital adequacy ratio is way above minimum requirements and is the highest in the domestic industry. This means the balance sheet is conservative and there is a lot of room to withstand shocks and/or invest surplus equity for growth and/or increase dividends.

In my estimation, Capitec has an additional impairment provision of about R3.2bn (equating to about R27 per share) that is over-reserved and very likely to be released over the next few reporting periods. Reported earnings, therefore, are still understated, and I believe we will witness strong earnings growth going forward.

For the critics of Capitec's apparently high price-to-book ratio, I would like to offer some perspective as food for thought. Over the past 20 years, Capitec has made massive investments in technology, distribution, and their brand. All, or almost all, of these were expensed through

profit and loss and constitute virtually nothing on the balance sheet. This is the best digital bank in South Africa with the fastest growth of active digital clients. It also was voted “coolest bank” by the South African youth. Are these assets – namely digital capability, distribution, and brand – really worth *nothing*? Maybe some of Capitec’s most valuable assets are not reflected in the financials, and maybe the price-to-book ratio is not as high as it seems.

I expect that, over time, our returns in this investment will follow Capitec’s earnings and dividend growth. In our opinion, the company has all the ingredients to compound at >20% for many years to come.

❖ **Argent (JSE: ART)**

Argent is an industrial conglomerate with about 24 underlying operating units across South Africa, the U.S., and the United Kingdom. Operations include steel-based trading, steel product manufacturing, security gates and fences, window shutters, bespoke trolleys for traditional and e-commerce retail, fuel storage and dispensing systems, concrete building products, and roll-over protection bars for construction machinery. Not a sexy business, and at around $50 million market cap it is obviously easy to ignore.

However, the company has been undergoing an unnoticed transformation. It used to be a low return value trap… until a new strategic shareholder stepped in a few years ago. Since then, Argent has been optimizing cash generation, disposing non-performing assets, acquiring high return assets, and buying back shares.

Argent reported the below interim results for the period ended September 2021.

- Revenue was up 21%.
- EPS was up 100% year-over-year.
- The company repurchased a further 6% of its outstanding shares during the preceding 12-month period.
- Cash conversion was excellent at 93%.
- On a net debt basis, the company is debt free.

These results become even stronger when we consider that the previous corresponding period was not a low base.

Argent executed two more inspired acquisitions. American Shutters is a major supplier of stylish door and window shutter systems and ties in well with Argent’s current offering through products like Xpanda security gates. Fluid Transfer Group is the leading UK manufacturer of aviation refueling dispensers and refuellers and is also a supplier of marine refueling systems and standard fuel tankers. Operating since 1967, the business has a global customer base and is well-positioned to capitalize on the return to normalized air travel.

To summarize, Argent is undergoing a sustainable transition to a higher return on capital model with a debt-free balance sheet, diversified income streams with the bulk of their earnings generated in the United Kingdom and United States, and excellent capital allocation execution. The company continues to buy back shares at a discount and has repurchased 38% over the past 5 years. Yet shares are deeply depressed, trading at a 5 PE and 0.7 price-to-book. We consider this a hidden gem with a clear path to value creation.

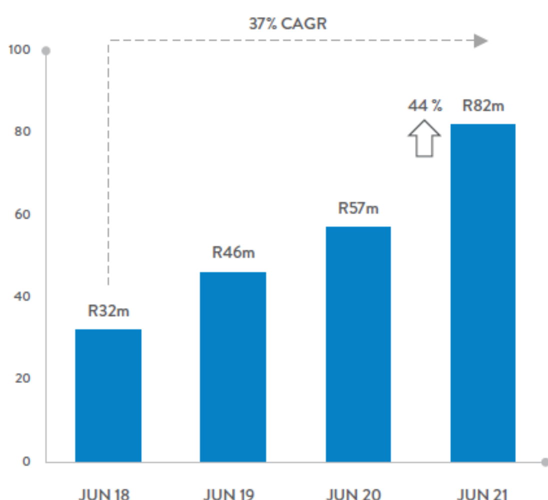
❖ Stadio (JSE: SDO)

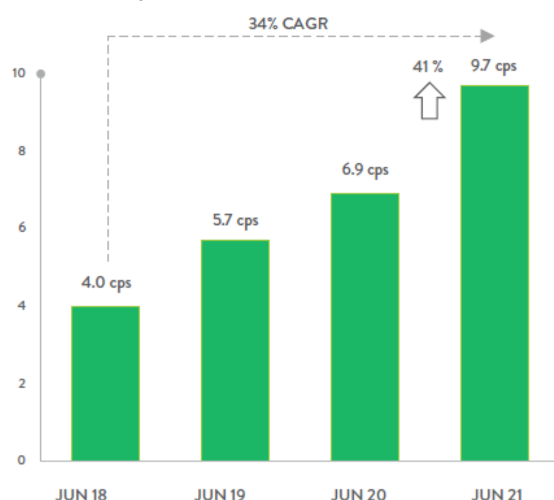
Stadio is a for-profit tertiary education (college/university) provider continuing to grow rapidly from a low base by accrediting additional academic programs and attracting new enrollments to their 80%-online/20%-contact offering. In addition to the demographic tailwinds and high demand driving Stadio's growth, COVID accelerated the growth and adoption of their online programs.

Stadio's earnings in the first half of the fiscal year clearly support our thesis of an early-stage business that has recently turned profitable and is growing EPS rapidly as operating leverage is kicking in. Despite disruptions caused by COVID lockdowns, student numbers are up +11% to 35,000, revenue is up +17%, EBITDA is up +34%, and, as highlighted in the chart below, EPS increased by+41%.

CORE HEADLINE EARNINGS

STADIO HOLDINGS





Stadio's balance sheet is unlevered and cash conversion is more than 100% thanks to the inclination of students to pay for studies in advance. We still see a long runway for growth for this small education company offering an affordable, high-quality product in a large and vastly under-serviced market.

❖ Mustek (JSE: MST)

Mustek is an importer, assembler, and distributer of IT products in the South African market. The business is well-positioned to benefit from the ongoing structural shift towards working from home and remote learning across basic education and higher education sectors. Recent investments into peripheral product lines such as networking equipment, sustainable energy, and fibre are starting to contribute meaningfully to performance.

Similar to Argent, Mustek is an underappreciated capital allocation story. The business is growing organically at a decent pace, generating heaps of cash, and buying back shares on the

cheap. Mustek has repurchased about 40% of their outstanding shares since 2014, and the buybacks are ongoing.

Mustek has been growing EPS at an average compounded rate of +17% per year over the past decade. The company is debt-free with surplus net cash on the balance sheet. Available, unutilized debt facilities of R1.3 billion represent more than 150% of its total market capitalization. A savvy buyer could fund a takeover from the company's own balance sheet.

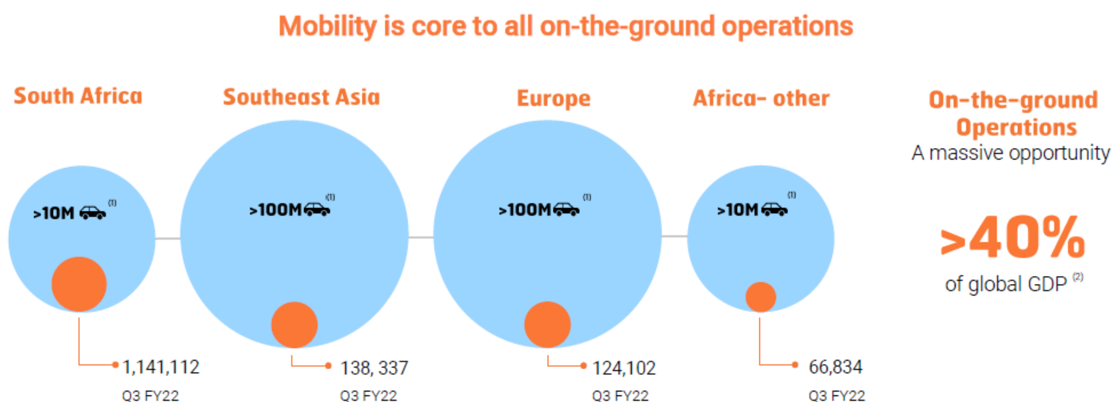
Mustek's current stock price puts the valuation at 0.7 price-to-book and 4 times after-tax earnings. I believe this is a below-average price for a business that offers a fortress-like balance sheet, continues growing EPS at a decent rate thanks to organic growth and share buybacks, and is a prime candidate for corporate action.

❖ Karooooo (JSE: KRO / NASDAQ: KARO)

Karooooo is a SaaS (Software-as-a-Service) company that maximizes the value of data collected from the monitoring and tracking of mobile assets (anything from mega mining trucks to scooters, generators, and even prisoners).

The company's reported Q3 results for the period ended November 2021 performed in line with our key metrics. Subscriber numbers are up 18% and revenue is growing at 20%. Karooooo has high revenue visibility with recurring subscription revenue accounting for 98% of the total. The GP margin was 68% and EBITDA margin 46%. Subscriber life cycle remained stable at 60 months, giving an LTV/CAS (lifetime value of subscriber divided by cost of acquiring a subscriber) of about 4.5 times.

It is clear that there is a massive total addressable market opportunity here, and Karooooo is one of the frontrunners in this "winner takes most" industry. There is a very long runway for growth and one can understand why the CEO passionately asserts that they are just getting started.



Karooooo management keeps evolving and innovating. According to CEO Zak Calisto, they are now thinking beyond connected vehicles and believe that there is significant untapped network value in the business. For example, its new vertical – an online vehicle trading

platform called Carzuka – will disrupt the used vehicle market by marketing, trading, financing, and insuring used vehicles with a complete telematics tracking history. Carzuka is currently gaining traction rapidly in in beta phase and is expected to launch in Q1 2023.

Management is clearly investing ahead of the curve. The combination of economies opening post COVID lockdowns and the benefits of growth initiatives flowing through is expected to result in accelerated EPS growth from 2022 onwards. I am very excited about Karooooo's prospects.

❖ **Naspers (JSE: NPN)**

In my opinion, Naspers/Prosus/Tencent has turned from one of the JSE's high valuation darlings into a contrarian bet with attractive valuations. I believe Tencent is a great asset, a combination of:

i) a dominant scalable platform,
ii) a host of high margin cash generative assets, and
iii) the best VC firm in the world (Tencent made 253 investments into new companies in 2021).

China-related concerns justify a higher risk premium and discount rate, but I do not believe Tencent is facing an existential crisis, and I do not believe that its earnings ability has been diminished. If anything, Tencent is incentivized to under-report earnings, so they are likely earning more than it appears. At the Prosus level, the market is seemingly ignorant of the non-Tencent portfolio – a slumbering giant in emerging market food delivery, online classifieds, and payments.

Naspers is not in favor at the moment. With Tencent off -40% from recent highs and Naspers trading at -60% discount to its look-through SOTP, I believe we own a fantastic collection of technology businesses with a huge margin of safety embedded in the discount.

❖ **Other positions**

We own several smaller positions and are buying more in:

- A small-cap importer, assembler, and distributor of a variety of consumer goods, that has been growing EPS at 15% CAGR over the past 9 years, trading at roughly 3 PE and 0.5 price-to-book.
- A global gold mining business with industry leading production costs and imminent volume increases coming online that are not yet recognized in the price.
- A niche supplier of highly specialized equipment to the mining and exploration sector.
- A tax efficient investment holding company with a proven track record of value creation and deal execution, trading at roughly 50% discount to underlying assets that are growing in value.

In closing

As always, I thank you for entrusting Desert Lion with your hard-earned capital. My responsibility is to you as partner and my wealth is invested in Desert Lion right alongside yours. I am driven, committed, and hungry to generate superior returns and enjoy the rewards with you. In the words of one of our founding partners, may 2022 be the year when it all comes together!

All the best,

Rudi van Niekerk

APPENDIX A: PERFORMANCE
Q4 REPORT FOR THE PERIOD ENDED DECEMBER 31, 2021

	Desert Lion Capital Fund I [1] %	FTSE/JSE All Share Index [2] %	Delta %
Q2 2019 [3]	3.1	6.0	(2.9)
Q3 2019	(10.8)	(12.3)	1.5
Q4 2019	13.9	12.7	0.8
Year 2019	4.8	4.7	0.1
Q1 2020	(41.4)	(39.0)	(2.4)
Q2 2020	12.8	25.8	(13.0)
Q3 2020	20.4	3.5	16.9
Q4 2020	39.7	24.7	15.0
Year 2020	11.2	-1.0	12.2
Q1 2021	15.8	11.3	4.5
Q2 2021	(2.0)	2.8	(4.8)
Q3 2021	(9.9)	(8.5)	(1.4)
Q4 2021	7.2	9.3	(2.1)
Year 2021	9.6	14.6	(4.9)
Cumulative [4]	27.8	18.8	9.0
Annualized [4]	9.3	6.5	2.8

Notes:

(1) Desert Lion Capital Fund I, LP ("Desert Lion") Standard Class, net of all fees. Based on an annual management fee of 0.75% (calculated quarterly in advance, charged monthly); fund expenses of 0.5% p.a. (charged monthly); 6% non-compounding hurdle; performance fee of 25% of profits exceeding the 6% hard hurdle; high water mark applies.

(2) FTSE/JSE All Share Index ("ALSH" or "J203") converted to USD returns.

(3) Inception April 1, 2019.

(4) Net results to a Limited Partner in the Standard Class as of April 1, 2019 inception. Individual returns will vary by class and date of investment.

Disclaimer:

PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.

The net returns presented under Quarterly and YTD Performance are net of all fees, expenses, and the incentive allocation attributable to a typical fee-paying limited partner in the Fund. The returns for a limited partner who has made additional subscriptions or withdrawals may differ. The performance numbers include dividends reinvested. This communication is for informational purposes only and is unaudited. Totals may not foot due to rounding.

DISCLOSURES

This letter (the "Letter") has been prepared solely for use by current and potential investors in Desert Lion Capital Fund I, LP (the "Fund"), which is managed by Desert Lion Capital Investment Management, LP (together with its affiliates, "Desert Lion Capital"), and shall be maintained in strict confidence. The recipient agrees that the contents of this Letter are confidential, the disclosure of which is likely to cause substantial and irreparable competitive harm to Desert Lion Capital and or its investment vehicles and their respective affiliates. Any reproduction or distribution of this Letter, in whole or in part, or the disclosure of its contents, without the prior written consent of Desert Lion Capital is prohibited. The information set forth herein does not purport to be complete and no obligation to update or otherwise revise such information is being assumed. Other events that were not taken into account may occur and may significantly affect the analysis. Any assumptions should not be construed to be indicative of the actual events that will occur. This Letter shall not constitute an offer to sell or the solicitation of an offer to buy which may be made only at the time a qualified offeree receives a private placement memorandum describing the offering and related subscription agreement. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. All information contained in this Letter is qualified in its entirety by information contained in the Fund's confidential private placement memorandum. An investor should consider the Fund's investment objectives, risks, charges and expenses carefully before investing. This and other important information about the Fund can be found in the Fund's offering memorandum. Please read the confidential private placement memorandum carefully before investing. The information in this Letter is only current as of the date indicated and may be superseded by subsequent market events or for other reasons. Statements concerning financial market trends are based on current market conditions, which will fluctuate. No representation or warranty (express or implied) is made or can be given with respect to the accuracy or completeness of the information in the Letter. Some of the statements presented herein may contain constitute forward-looking statements. These forward-looking statements are based on current expectations, estimates and projections. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Although Desert Lion Capital believes the expectations reflected in any forward-looking statements are based on reasonable assumptions, Desert Lion Capital can give no assurance that such expectations will be attained and therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. Desert Lion Capital undertakes no duty to update any forward-looking statements appearing in this Letter. Investment in securities involves significant risk and has the potential for partial or complete loss of funds invested. Diversification does not assure a profit or guarantee against loss in declining markets. Investors should consider their investment objectives, risks, charges and expenses of the underlying funds before investing. The views, opinions, and assumptions expressed in this Letter are as of the date of this Letter, are subject to change without notice, may not come to pass and do not represent a recommendation or offer of any particular security, strategy or investment. The Letter does not purport to contain all of the information that may be required to evaluate the matters discussed therein. It is not intended to be a risk disclosure document. Further, the Letter is not intended to provide recommendations, and should not be relied upon for tax, accounting, legal or business advice. The persons to whom this document has been delivered are encouraged to ask questions of and receive answers from Desert Lion Capital and to obtain any additional information they deem necessary concerning the matters described herein. None of the information contained herein has been filed or will be filed with the Securities and Exchange Commission, any regulator under any state securities laws or any other governmental or self-regulatory authority. No governmental authority has passed or will pass on the merits of this offering or the adequacy of this document. Any representation to the contrary is unlawful.

References to the MSCI Emerging Markets Index ("MXEF") and the FTSE/JSE All Share Index (JSE alpha code "ALSH" or JSE index code "J203") are based on published results and, although obtained from sources believed to be accurate, have not been independently verified. The MSCI Emerging Markets Index is referred to only because it represents an index typically used to gauge the general performance of the midcap and large caps in global emerging equity markets in more than two dozen emerging market countries including South Africa, China, India, Korea, Mexico, Taiwan, the United Arab Emirates and others. The returns for the MSCI Emerging Markets Index include realized and unrealized gains and losses plus reinvested dividends but do not include fees, commissions and/or markups. The FTSE/JSE All Share Index is referred to only because it represents an index typically used to gauge the general performance of the Johannesburg Stock Exchange as a whole. The returns of the FTSE/JSE All Share Index include realized and unrealized gains and losses, but do not include the reinvestment of dividends, and do not include fees, commissions and/or markups. The use of these indices is not meant to be indicative of the asset composition, volatility or strategy of the portfolio of securities held by the Fund. The Fund's portfolio may or may not include securities which comprise the MSCI Emerging Markets Index and the FTSE/JSE All Share Index, will hold considerably fewer than the number of different securities which comprise the MSCI Emerging Markets Index and the FTSE/JSE All Share Index and engages or may engage in Fund strategies not employed by the MSCI Emerging Markets Index and the FTSE/JSE All Share Index including, without limitation, short selling and utilizing leverage. As such, an investment in the Fund should be considered riskier than an investment in the MSCI Emerging Markets Index and the FTSE/JSE All Share Index. Furthermore, indexes are unmanaged, do not incur management fees, costs, and expenses, and cannot be invested in directly.