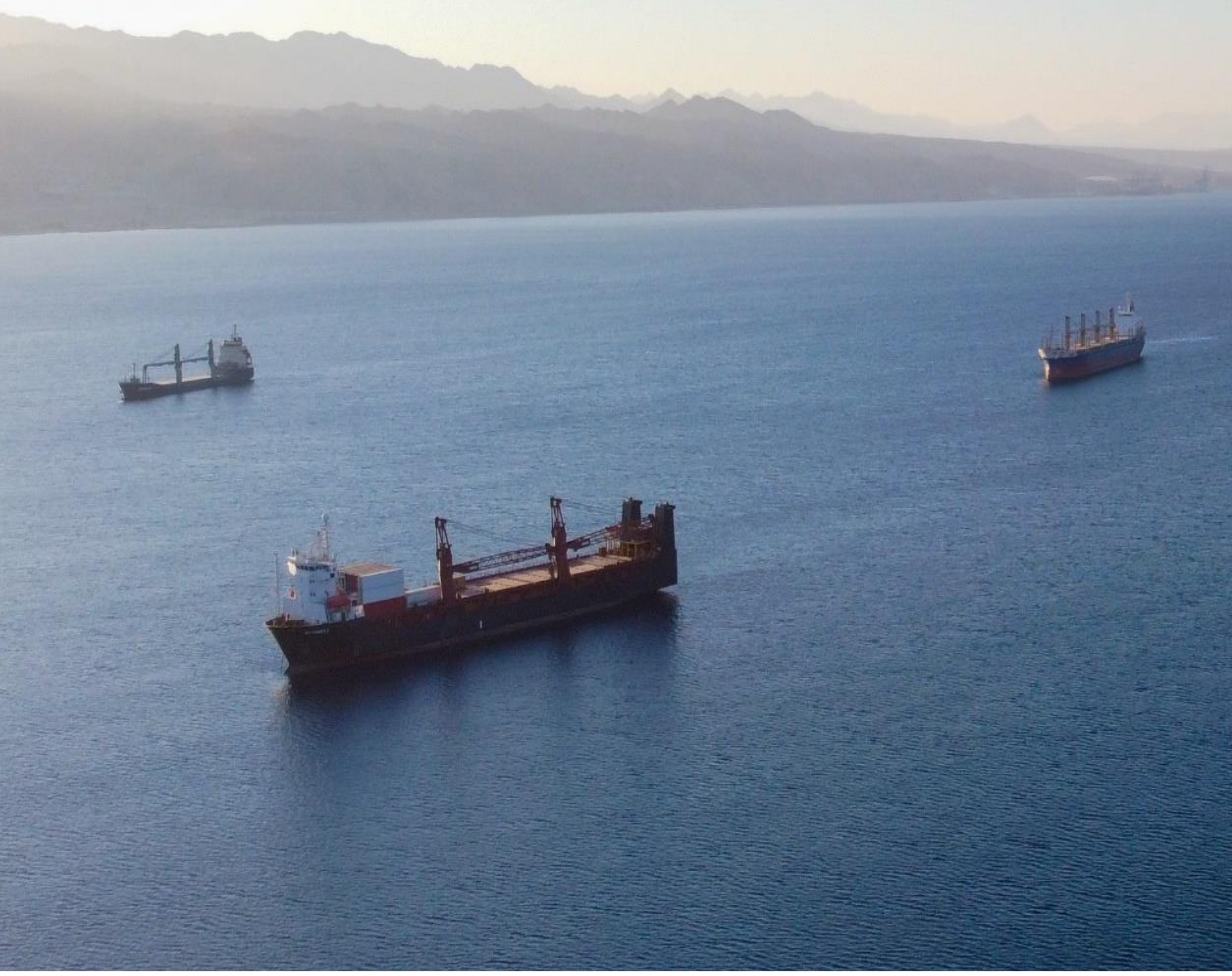

FLAGSHIP
ASSET MANAGEMENT

Quarterly Telescope Q3 2023

Flagship Asset Management · Constantia, Cape Town · +27 (0)21 794 3140 · info@flagshipsa.com

01

We are a global specialist investment boutique

Flagship is a specialist global asset manager founded in 2001.

We are 100% independent and fully owned by staff and directors.

Our mission is to be the navigators and global authority of your complete investment future, wherever it may lead.

02

We manage global portfolios in three distinct strategies

Global Equity | Global Flexible | Global Fund of Funds

We believe in a focused approach to fund management

Our longest running Funds have track records spanning over two decades

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03

We are long term investors who manage concentrated portfolios

Our investment approach is process-driven and rigorous, and our definition of quality is demanding and exclusive.

Our equity portfolios are focused. We own a maximum of 30 shares, diversified across geography and sector.

Contents

Page

The Flagship Global Investment Team

Kyle Wales CA (SA), CFA

Kyle is a fund manager of the global funds at Flagship and has been investing internationally for over 15 years. Prior to Flagship, he worked at Coronation Fund Managers for 9 years in the Global and Global Emerging Markets teams and also co-managed a global equities boutique at Old Mutual Investment Group. Kyle is a qualified chartered accountant and CFA charter holder.

Philip Short BSc (Maths), CFA

Philip is a co-fund manager of the flexible strategies at Flagship and brings specialist macroeconomic expertise to the global team. Philip has gained 19 years' experience in the industry at JP Morgan, Fairtree Capital and Old Mutual as an analyst and portfolio manager. He completed his Bachelor of Science in Mathematics at the University of Pretoria and is a CFA charter holder.

James Hayward (BEng)

JD, as he prefers to be known, is a co-fund manager of the flexible strategies at Flagship, while also fulfilling an equity analyst role for the global team. Prior to Flagship he worked as an engineer and also spent 2 years at an Edu-tech startup in Cape Town. JD graduated from Stellenbosch University with a BEng (Civil) in 2016 and has passed all three levels of the CFA exam.

Gerhard Janse van Vuuren (BCom)

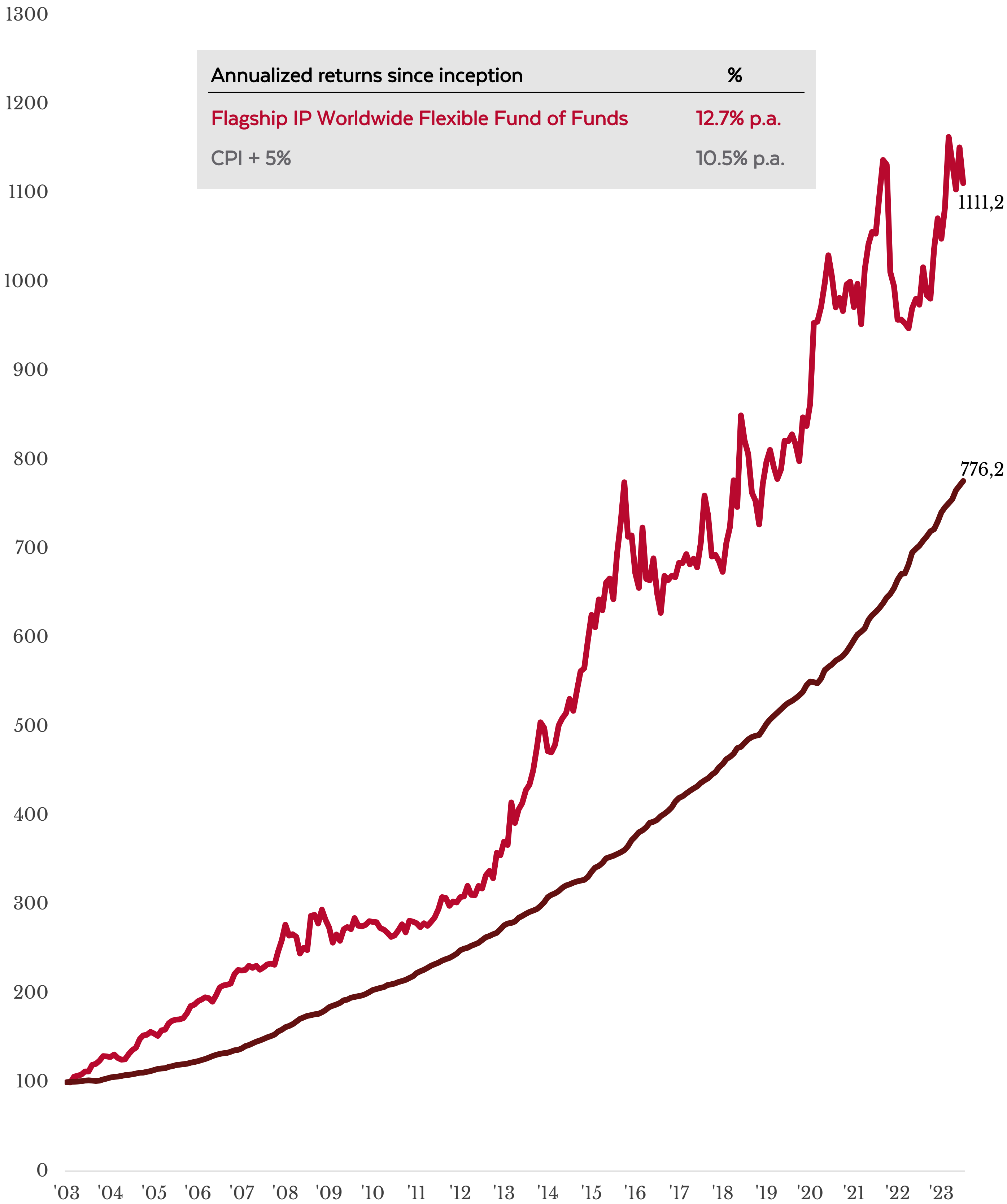
Gerhard is an equity analyst for the global team at Flagship. He completed several investment internships while concluding his degree in Investment Management at the University of Stellenbosch. Gerhard has passed Level 1 of the CFA exams and is currently furthering his studies with an Honours degree in Finance at the University of Cape Town.

The Power of Long-term Compounding

The **Flagship IP Worldwide Flexible Fund of Funds** (net of all fees) vs. SA CPI +5%

from 3 April 2003 to 30 September 2023 (20 years, 6 months)

Annualized returns since inception	%
Flagship IP Worldwide Flexible Fund of Funds	12.7% p.a.
CPI + 5%	10.5% p.a.

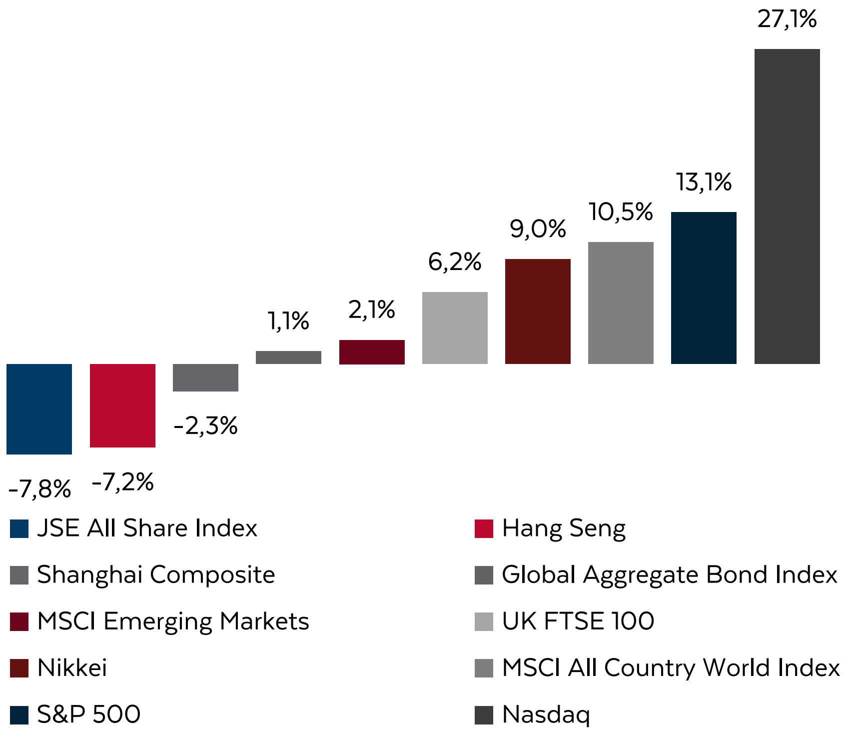


A recessionary tale

"To be, or not to be, that is the question."

- William Shakespeare

Chart 1: Global Index returns YTD in USD (Dec 31, 2022 to September 30, 2023)



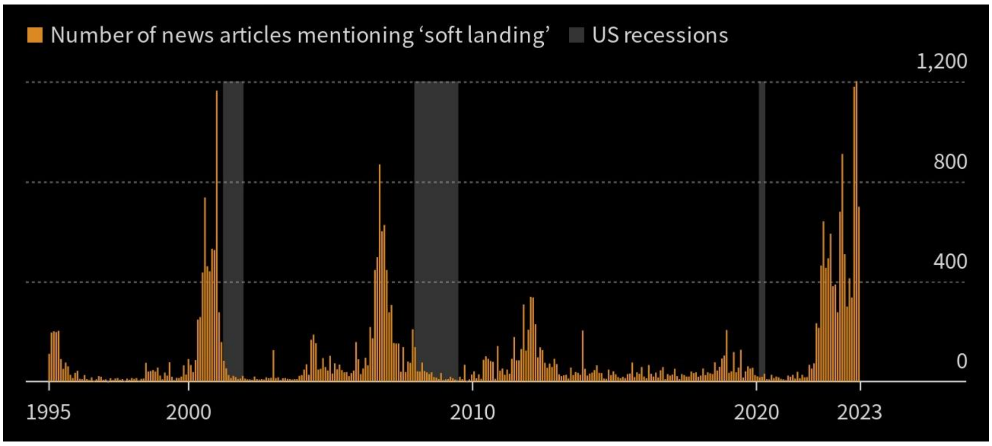
The voices on soft landings were loudest right before the actual recessions in 2001 and 2008.

The third quarter was one of two halves with the initial momentum carrying over from quarter two. As US 10-year bond yields rallied in August and September (and bond prices fell), equity markets retreated somewhat. The Nasdaq is still the envy of all markets, although, within the Nasdaq, the performance can be attributed to only a handful of companies. It is probably not a surprise that the JSE All Share Index had a disappointing return year to date given the struggling economy and the absence of strong political leadership.

Soft landing

The markets entered the third quarter with renewed optimism, the primary cause being the theme of Artificial Intelligence (AI). Nvidia put out a brilliant, market-beating set of results in May that laid the foundation for this optimism. That led to certain heavyweight companies rallying, pulling the rest of the market with them. At the same time, we saw the US post decent real GDP data in July and August, both above 2%, and inflation continued coming down. Consumer spending was positive, but only just. Market analysts were increasing their earnings forecasts for US companies. Ergo, the calls for a soft-landing or no recession began to grow louder. This should not, in itself, be a source of comfort, as the voices on soft landings were loudest right before the actual recessions in 2001 and 2008.

Chart 2: Soft landing hopes and hard landing realities, Bloomberg



It is tempting to get sucked into market narratives as much as it is comfortable to stick to your original views. New data needs to be tested. Your assumptions need to be challenged. Debate should be encouraged.

Digging deeper

Three macro backdrops occurring in the third quarter that have kept us at Flagship wary of assuming a soft landing:

1. Stronger oil price: Brent oil increased 25% in price in Q3 alone. Although Energy on its own is excluded from the Core Inflation measure, it still has a second-round effect on almost all goods. The oil price was largely driven by OPEC+ supply cuts, which are with us until year-end, at least. With US oil reserves and inventories at multi-decade lows, this is a concern, and could support oil prices as the US builds up strategic resources.
2. The US Dollar strengthened: this might help US inflation at the margin but it is a drain on global liquidity and makes everything more expensive for all other nations. Commodities are priced in US Dollars as well as a major portion of global sovereigns' debt.
3. US 10-year bond yields have whipped higher, which is a warning signal for bond and equity investors alike. There are a number of reasons why yields would be higher. Stripping out the one possible reason, being global growth coming in higher than expected, which it hasn't, none of the remaining reasons are positive (higher inflation expectations and/or risk aversion to US safety assets).

Other US indicators that all point to a recession: an inverted yield curve, weak global Purchasing Managers' Indices, tighter corporate lending activity (reflected in tighter lending standards and higher spreads), rising corporate bankruptcies, declining year-on-year federal tax receipts and more.

A big theme we are also witnessing is the lagged effect of monetary policy tightening.

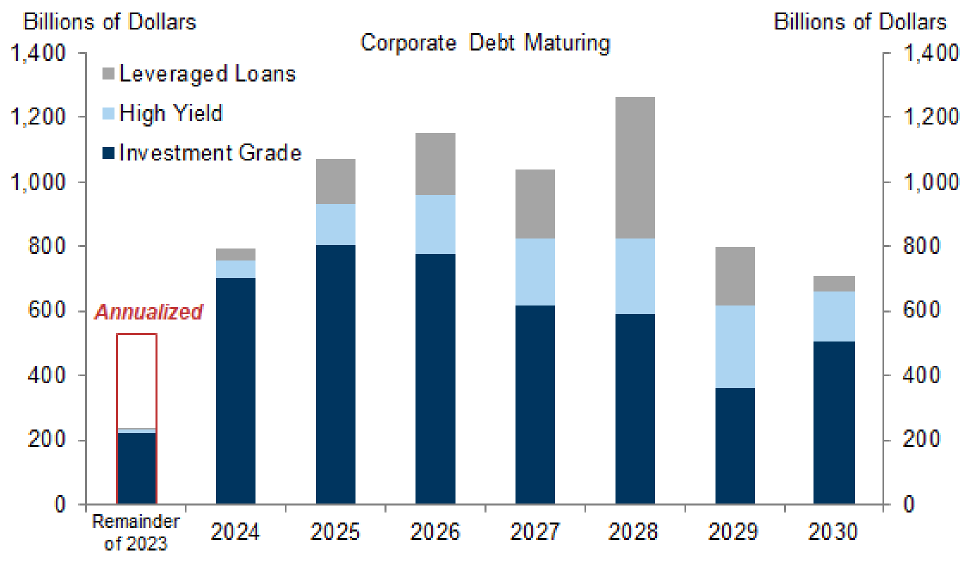
A big theme we are also witnessing is the lagged effect of monetary policy tightening. As the Federal Reserve increases interest rates, the full effect is only felt ~18 months later. A great example of this is looking at US corporate balance sheets.

US corporate balance sheets

Net interest paid by US corporates has been flat since 2021 and below pre-pandemic levels. How is that the case when interest rates on Investment Grade and High Yield debt has doubled since 2021? 1) Corporates refinanced their debt during the pandemic at lower rates, and 2) corporates have increased their net cash levels over the years such that they are now earning greater interest income on that cash as interest rates have risen.

The lagged effect occurs when existing debt matures over time and needs to be refinanced at higher rates. That first tranche of debt that needs to be refinanced is coming due now and will grow over the next few years.

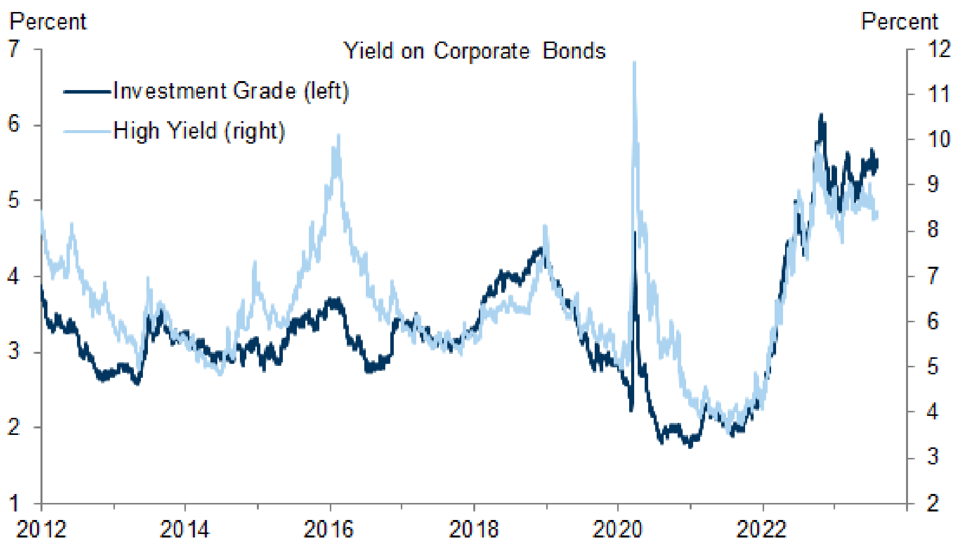
Chart 3: Size of corporate debt maturing until 2030 (in USD billions), Goldman Sachs



The result is a larger amount of debt being refinanced at much higher rates which increases net interest expense materially. Interest rates on corporate debt have doubled over the last 18 months.

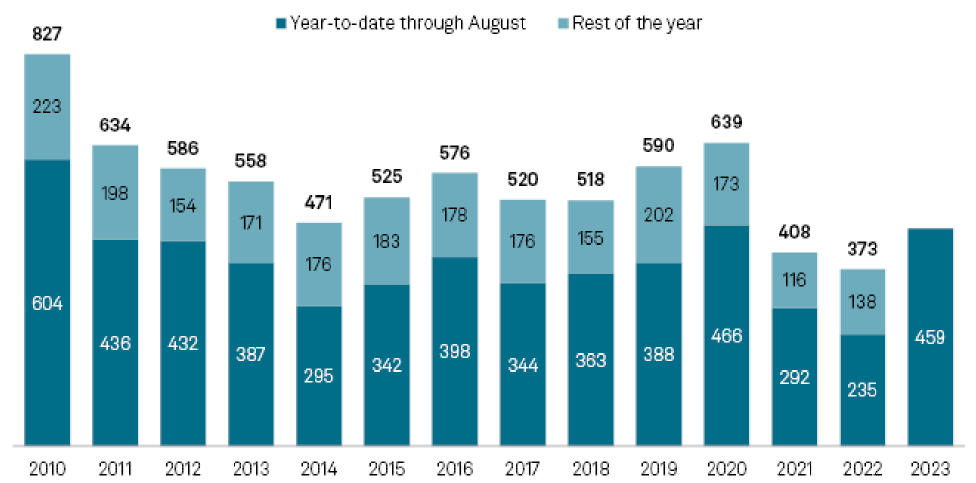
Chart 4: Interest rates on corporate debt from 2012 to August 2023, Goldman Sachs

Interest rates on corporate debt have doubled over the last 18 months.



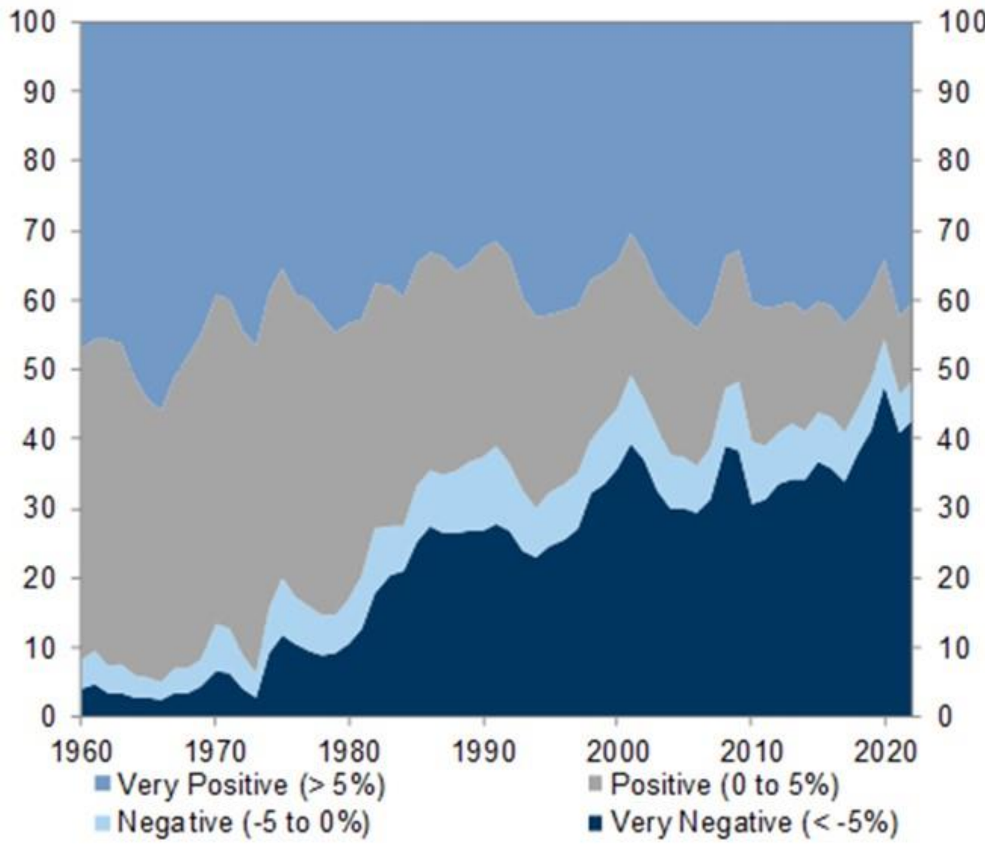
Currently, bankruptcies are on the rise, due mainly to higher interest rates. If inflation stays high, rates will stay higher for longer, and more bankruptcies will occur. This will lead to higher unemployment, lower economic growth and even more bankruptcies.

Chart 5: US bankruptcy filings by year, S&P Global



Finally, we think things are potentially worse than they appear, because we've lived through a period of cheap money for too long. US interest rates have been declining ever since the early 1980s, to the point where some government bonds were yielding negative rates. Ultra-low rates allow unproductive companies to survive for longer than is warranted. With the higher rates that we are experiencing today, these "zombie" companies will get burnt and roll over. It is startling to see that nearly half of all publicly listed companies in the US are making a net loss.

Chart 6: Share of all publicly listed firms by profit margin (in %), Goldman Sachs



Finally, we think things are potentially worse than they appear, because we've lived through a period of cheap money for too long.

Asset Allocation

We remain cautious on global markets and are of the view that we will be heading for a recession rather than the consensus view of a soft landing.

Flagship is first and foremost a global asset manager. This gives us a vast universe of geographies, sectors and companies that you just cannot get exposure to in a South African fund.

Equities are the asset class which have been the best preserver of real wealth over time and this is why you can expect your funds to have a major allocation to equities on a through-the-cycle basis. As written in our Q2 2023 Telescope, we remain cautious on global markets, and are of the view that we will be heading for a recession rather than the consensus view of a soft landing. Even with all the risks outlined above, the market is still not cheap, with the S&P500 trading 10%-20% above its 10 and 20-year average forward PE valuation, respectively.

The current forward PE ratio of our Global Equity strategy is 11.5X vs the MSCI ACWI (All Country World Index) at 15.5X. Our Global Equity strategy has a current Beta of 0.65 vs 1.0 for the ACWI. Beta measures a portfolio's move relative to the overall market. A Beta of less than 1 indicates a portfolio with lower volatility than the market and vice versa. These metrics illustrate that our Global Equity strategy is invested in more attractively priced assets that should outperform the ACWI in a downturn.

In our Flexible and Fund of Funds strategies, we are at our own self-imposed lower limit of 58-60% invested in equities, with 35% in cash or near-cash interest bearing instruments that are yielding 4-5% in US Dollars. This provides a good income return in hard currency while taking very little to no duration risk, and the option to tilt more into equities when the opportunities present themselves.

Strategy Performance

The performance of the Flagship Strategies over the quarter, year-to-date and 1 year to 30 September 2023 are shown below.

Fund of Funds Strategy	Q3 '23	%Δ YTD	%Δ 1YR
Flagship IP Worldwide Flexible Fund of Funds (ZAR)	-2.1%	13.2%	14.0%
Flexible Strategy	**Q3 '23**	**%Δ YTD**	**%Δ 1YR**
Flagship International Flexible Fund (USD)	-1.3%	1.9%	8.1%
Flagship IP Worldwide Flexible Fund (ZAR)	-0.5%	12.6%	14.7%
Global Equity Strategy	**Q3 '23**	**%Δ YTD**	**%Δ 1YR**
Flagship Global Icon Fund (USD)	-1.4%	1.3%	14.9%
Flagship IP Global Icon Feeder Fund (ZAR)	-1.8%	11.9%	18.1%

Our Fund of Funds strategy has returned 13.2% year-to-date and is ahead of its CPI +5% target which returned 8%. We are currently only 60% invested in equity in this strategy. If one looks at the third quarter specifically, the largest contributor was Invesco's S&P500 GARP ETF (up 1.4% in the quarter where the ACWI was down 2.8%), GQG's Emerging Market Fund (up 2.2%) and the iShares MSCI World Value ETF (up 0.4%). Leading the detractors was the Lindsell Train Global Equity Fund followed by the Gold ETF we own and finally the Guiness Global Innovators Fund.

Similar to the Fund of Funds strategy, we are currently only 60% invested in equity in our Flexible strategy, for which I will use the Flagship IP Worldwide Flexible Fund as a proxy, as it is our longest-running fund within this strategy. The fund returned 12.6% year-to-date versus its composite benchmark which returned 9.4%. The largest contributors for the quarter were Capri (up 47% as a result of the Tapestry acquisition), Schlumberger (up almost 20% on account of the stronger oil price) and Alibaba. The largest detractors were Square Enix, Ultra Clean and Zalando.

The third quarter saw much activity in our strategies.

Our Global Equity strategy is up 1.3% year-to-date in USD (11.9% in ZAR), versus its benchmark which is up 10.5% in USD. The largest contributors for the quarter were Capri, Schlumberger and Agesa holdings, a Turkish life-insurer (which was up 98% in USD). The largest detractors were Square Enix, Ultra Clean and Tapestry.

The third quarter saw much activity in our strategies. The following are the notable trades during the quarter:

Hensoldt & Thales (buy)

Hensoldt and Thales are both European defence companies. Neither of them make actual defence platforms (tanks/helicopters/fighter jets) but they equip those platforms with sensors or optronics. Since the war in Ukraine began, European countries have committed themselves to increase their defence spending to bring it in line with Nato's minimum levels of 2% of GDP. As a result of this, Thales (whose main client is the French government) and Hensoldt (whose main client is the German government) have a clear line of sight to revenue growth of between 5-7% and 10% p.a. respectively, over the next decade. Both these companies trade on sub 16X multiples, which is below the level we would use for the "average" European company, despite the fact that they have far more robust (and certain) growth outlooks.

In Q3 we bought Hensoldt, Thales, BAT, Concentrix, Ipsos and Euronext

British American Tobacco (buy)

The British American Tobacco (BAT) share price has come under pressure due to regulatory movements in the USA, where BAT generates 45% of its profits. Even if all the regulation that the market fears comes to fruition, we believe BAT is well placed to continue growing earnings due its Next Generation Products, which includes vaping. BAT has the largest vaping market share in the US and globally. We bought BAT at a 10% dividend yield and a forward PE of 6.5X. We highlight the investment case for BAT and tobacco stocks in general later on in this Telescope.

Concentrix (buy)

Concentrix is one of the largest global players in the customer experience industry. They have evolved from a call-centre operator into a trusted partner to some of the world's largest companies. In so doing, they act as a middleman between these firms and their clients. Concentrix's customers clearly value their service, as the average tenure of their 25 largest customers is more than 16 years.

Recent fears emanating from the rise of Generative Artificial Intelligence has caused the stock price of Concentrix (and its peers) to fall. We believe the market is overestimating the risk posed by GenAI, and not fully appreciating Concentrix's position in the value chain. This has provided an entry point at a steep discount below what we believe is the stock's fair value.

Ipsos (buy)

Ipsos is one of the largest market research and polling companies in the world, operating in 90 markets and employing nearly 20,000 people. Ipsos is an example of a steady compounder which is priced too cheaply. Between 2022 and 2025, Ipsos is targeting organic growth of between 5-7% and is targeting to expand EBIT margins from 13-15%. Its track record of meeting its guidance is excellent. Market research is a business with favourable dynamics. Returns on tangible equity are high and (because reinvestment requirements are low), in addition to organic growth, Ipsos has substantial scope to consolidate the industry as its market share is only 3-4%. All this for 8X earnings (or a PEG ratio below 1X).

Euronext (buy)

Euronext is a pan-European Stock-exchange. It is the second largest exchange in Europe, behind the London Stock Exchange (LSE), and the largest in terms of equities traded on its platform. The aggregate market cap of equities listed on Euronext is almost twice that of the LSE. Stock exchanges are businesses with entrenched network advantages, high margins and great free cash flow conversion. Counter-intuitively, stock exchanges also tend to be quite defensive. The bulk of Euronext's fees are calculated as a percentage of value traded. However, in market sell-offs, even though share prices fall, increases in volumes traded more than compensates for this. Euronext trades on 14X earnings.

Switched Suncor into Shell & TotalEnergies

We have divested our Suncor Energy holdings in exchange for Shell and TotalEnergies. The reason for the switch being that Suncor purely has oil exposure, whereas the other two companies are a play on overall energy demand, which includes renewables as well as oil. Shell and TotalEnergies are also more attractively valued and both have articulated their strategy for higher shareholder returns in the form of dividends and share buybacks.

Switched Anheuser-Busch InBev into Heineken

We believe both Anheuser-Busch InBev (ABI) as well as Heineken are very attractively priced but, post its recent share price underperformance, we have a marginal preference for Heineken. Heineken now trades at a small discount to ABI despite the fact that it is expected to grow revenues quicker (at 8% versus ABI's 4%) and has more scope to expand margins. Both trade on PEs of under 16X.

Switched Capri into Tapestry

As you know, we have been constructive on Capri for a while. Post Tapestry's acquisition of Capri, we became positive on Tapestry, because we believe the price they paid for Capri substantially undervalued Capri's business. Tapestry will also benefit from the announced merger synergies of the deal going forward. We highlight the investment case of Capri vs Tapestry later on in this Telescope.

In Q3 we switched Suncor into both Shell & TotalEnergies, ABI into Heineken and Capri into Tapestry.

In terms of shares we sold:

We sold Applied Materials, Microsoft and Universal Music Group because they had reached our estimation of their fair values.

We also sold Zalando and Dicks Sporting Goods, both of which are consumer discretionary stocks. We felt that the funds had too much exposure to consumer discretionary stocks already, given our cautious stance on the world.

Finally, we sold Take-two Interactive and International Flavours and Fragrances (IFF) as we felt that risks to both investment cases made it imprudent to hold them. Take Two is the owner of the much vaunted "Grand Theft Auto" gaming franchise and the market was pricing in a perfect outcome, both in terms of the sales of Grand Theft Auto VI (the next instalment of the eponymous franchise), as well as its release date. In the case of IFF, we had seen three downward guidance revisions in quick succession. This was not entirely the fault of management, but their insistence on paying a dividend is placing the balance sheet under pressure, and making a capital raising or a forced sale of one (or more) of their prized assets, at an inopportune time, a virtual certainty. We believe this outcome is not fully discounted by the market and this might lead to another leg down in the share price.

Scratching below the surface of tobacco companies

By Philip Short

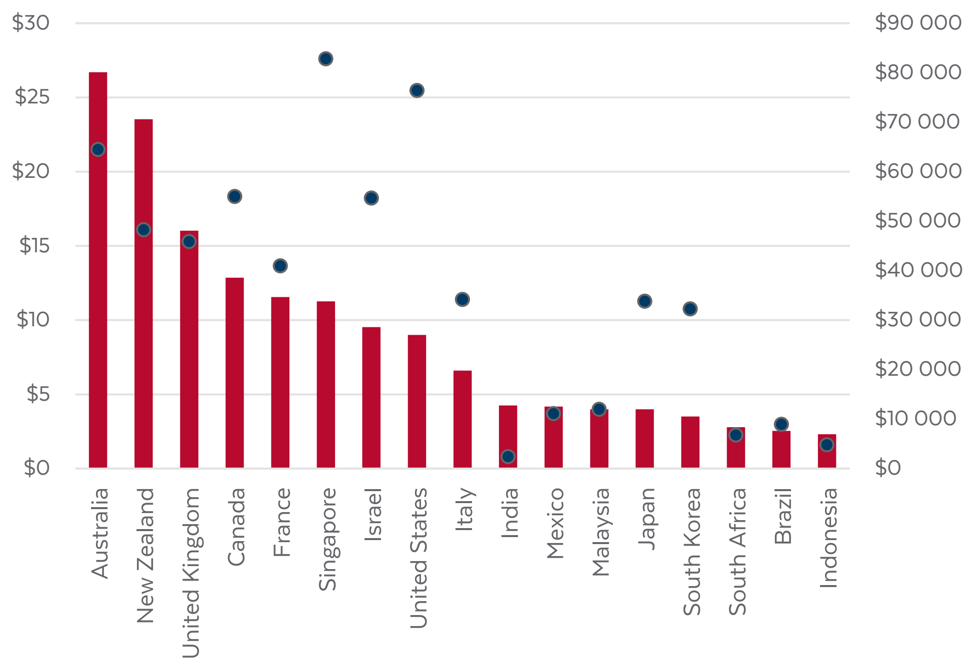
Consumers' first thoughts on tobacco companies are generally "unhealthy; addictive; money machines". As an investor, one thinks "over-reaching regulation; a dying industry; money machines". Unenviable characteristics that one would prefer to avoid... except that money machine trait. That sounds interesting enough for us to scratch below the surface.

Regulation

Regulation is the biggest red flag when looking to invest in tobacco companies. Regulators dictate what products tobacco companies may and may not sell, and governments can increase taxes on tobacco products to the point where they become unaffordable. One of the more stringent regulators is the US Food and Drug Administration (FDA). This is a cause of concern for British American Tobacco (BAT) investors, because the FDA have flexed their muscle over the tobacco companies of late, and forty percent of BAT's revenue is derived from the US.

How did the US become such a large percentage of BAT's revenue? BAT used to own 42% of Reynolds American Inc. (the vehicle through which it had exposure to the US), and bought the remaining 58% in 2017. Why? The US still has a long runway of pricing power. Looking at where a box of cigarettes is sold worldwide in US$ versus GDP/capita, one can see that affordability still has far to go in the US.

Chart 7: Price of Marlboro 20s (left axis) vs GDP/capita (right axis, in USD)



The effects of regulation, and the unquestionable evidence of the harm that combustible products inflict upon users, has pushed tobacco companies towards Next Generation Products.

Additionally, BAT's operating profit margins are higher in the US at 54% versus the 44% average for the Group. While traditional smoking product volumes, i.e. combustibles, are expected to decrease, the favorable pricing environment will more than offset this for at least the medium term (5+ years), resulting in a positive price/mix.

However, we'd would like to see something more tangible, beyond the medium term that the combustible portfolio currently offers. What happens one day when combustible prices are too high and unaffordable, and volumes too low? How far will regulation go? How are tobacco companies positioning themselves for this?

Next Generation Products

The effects of regulation, and the unquestionable evidence of the harm that combustible products inflict upon users, has pushed tobacco companies towards Next Generation Products (NGPs).

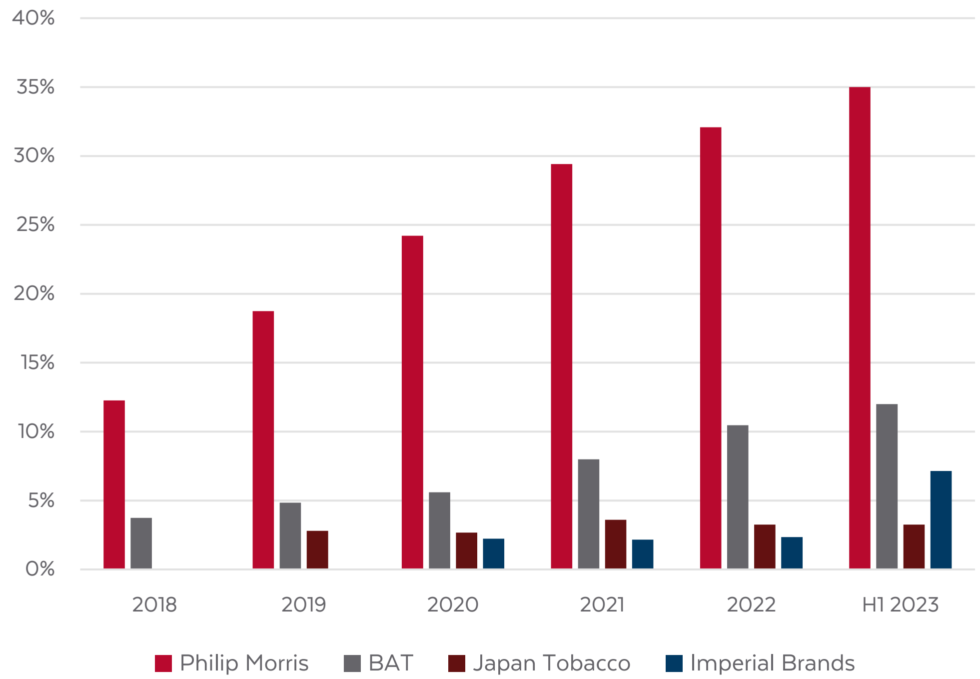
BAT and Philip Morris International (PMI) are leading the way when it comes to reduced risk products (RRP); products that studies have shown to be less harmful than combustibles. The global set of RRP include the following:

- Vapour, or E-cigarettes: vaping simulates smoking by creating an aerosol that appears like a vapour and contains nicotine, although no tobacco. It does not contain the harmful tar associated with cigarettes, but does contain other chemicals.
- Tobacco Heated Products (THP): a tobacco stick that is inserted into a heating device which brings the temperature of the stick to just below burning point. Compared with cigarettes, THP's deliver up to 83% of nicotine while reducing levels of harmful toxicants by at least 62%, and particulate matter by at least 75%.
- Modern Oral (MO): a small pouch filled with nicotine, water and flavorings (no tobacco), placed between the upper lip and gum, where the nicotine and flavors are released over 20-30 minutes.

BAT Revenue from NGPs was up 29% and now make up 12% of Group sales.

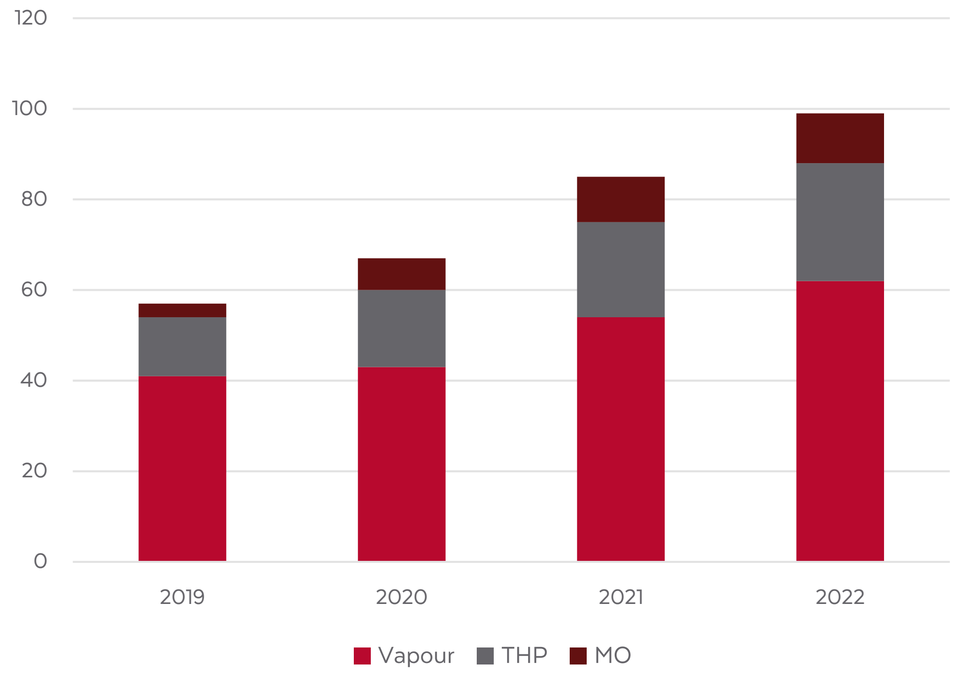
BAT reported Group revenue growth of 4.4% over the first half of 2023. Traditional combustible revenue was up 1.8% while revenue from NGPs was up 29%. NGPs now makes up 12% of Group sales and this will become a greater part of the mix going forward.

Chart 8: NGP as a percentage of total revenue



Whereas combustible volumes are decreasing, the NGP category is drawing in new users, either through existing combustible smokers switching to NGPs as well as consumers who are new to the nicotine category as a whole.

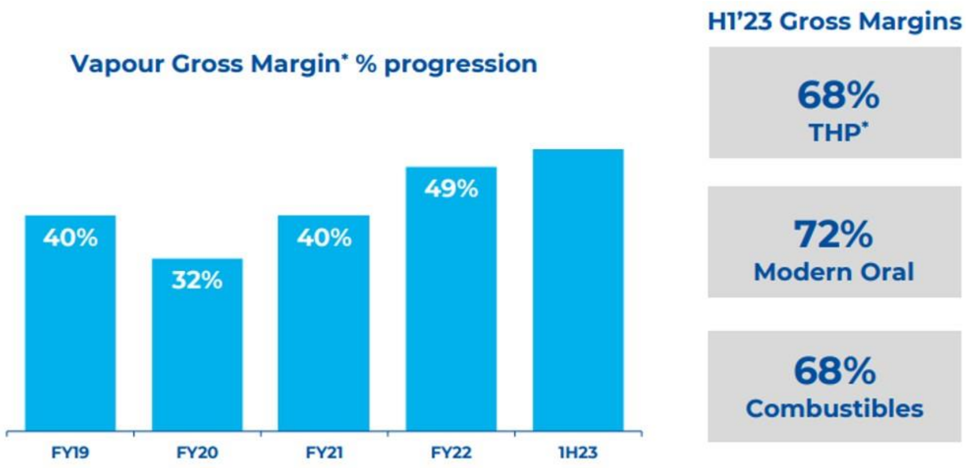
Chart 9: NGP consumers worldwide (in millions)



BAT has positioned itself well in the vaping market, with a leading market share globally and in the US of 36% and 47%, respectively; North America alone has 44% revenue share of the global vaping market. Vaping is clearly a growing business. Given that existing combustible products are high margin, the question is, will the growth in NGPs be margin accretive or dilutive?

BAT has positioned itself well in the vaping market, with a leading market share globally of 36%.

Chart 10: BAT's vapour gross margin progression (%)



NGPs are at, or trending towards, combustible gross margins. The dynamics in the trending margins for e-cigarettes are that you either get a refillable or a disposable product. For the refillable pods or cartridges, you first buy the e-cigarette device as a once-off (which is low margin and often subsidized by the company), and then you continuously refill the device with nicotine liquid which is higher margin. Thus, we expect vaping margins to increase further.

On an operating margin basis, there has been a significant amount of R&D going into NGPs which gets deducted from gross profit. This has resulted in the NGP portfolio being loss making at an operating profit level, to the amount of £1bn in 2020. Even so, BAT is expected to generate free cash flow of £8.6bn over its entire portfolio (combustibles plus NGPs) for FY 2023. We see sufficient runway for combustibles before the NGP portfolio takes the lead in growing cash flow for the Group.

Conclusion

Regulatory risks mean that combustible volumes will continue to decline, albeit with better pricing to offset this in the short to medium term. The FDA will move against flavours, such as menthol, in both cigarettes and e-cigarettes. This is important for BAT because 25% of group profits come from US menthol. In December 2022, the State of California banned menthol cigarettes and menthol flavoured e-cigarettes. Yet BAT managed to retain 90% of sales through menthol users switching to normal flavoured cigarettes and e-cigarettes, as well as some consumers buying menthol from neighbouring states.

BAT currently trades on a rolling forward PE and EV/EBITDA of 6.7x and 6.9x respectively, and a dividend yield of 9.4%, with annualized earnings expected to grow in the mid to high single digits over the next 3+ years. Taking the worst-case scenario and assuming every US state bans every menthol product, and that every menthol user quits nicotine completely (combustible and vaping), then BAT will trade on a still reasonable 8.9X PE and a 7.1% dividend, assuming the share price stays constant.

BAT is moving away from being a tobacco company to more of a nicotine company.

BAT is moving away from being a tobacco company to more of a nicotine company. The transformation to a less harmful product portfolio which has a longer growth runway should lead to a less regulated sector in time – and it will still be a money-making machine.

Investment Case: Capri vs Tapestry

By Kyle Wales

- ⇒ Tapestry recently made an offer to acquire Capri, a long-term holding in your funds.
- ⇒ Should the merger proceed as planned, the combined company would be the holder of the Coach, Kate Spade and Stuart Weitzman brands (these are all ex-Tapestry) and Michael Kors, Jimmy Choo and Versace (all ex-Capri).
- ⇒ We believe Tapestry not only stands to benefit from having bought Capri at a great price, but from the synergies of the deal as well.
- ⇒ Post the unjustified fall in the Tapestry share price, we have switched our holding from Capri to Tapestry.

> Tapestry stands to benefit from having bought Capri at a great price and from the synergies of the deal as well.

One of the challenges with investing is that it can take a while for your investment thesis to play out. This is a challenge because while you wait, it may be a huge source of discomfort for both you and your clients, as your investment positions temporarily move against you. This frequently happens. To use one example, Amazon had fallen greater than 90% from its Dot.com highs to its all-time low in September 2001 before it began its inexorable climb upwards. Another example, closer to home, is that of Capitec. From the time of its listing on the JSE in February 2002, Capitec had fallen by 55% a mere month later, as the "Small Bank's Crisis of 2002/3" (which led to the demise of Saambou Bank amongst others), unfolded.

This tendency to experience discomfort when investment prices fall is not aided by "Loss aversion", a documented behavioural bias, where it has been observed that the pain people experience from losing is psychologically twice as powerful as the pleasure they experience from gaining. In a worst-case scenario, you may be forced to throw in the towel completely, just before things turn. The most notable example of this is perhaps Michael Burry, who was made famous by the movie "The Big Short". He made billions betting against the subprime market during the Global Financial Crisis, but almost did not live to see his bet pay-off, due to an investor revolt which saw millions of dollars being withdrawn from his funds because his bet initially moved against him.

For us, an example of an investment case that initially moved against us, but ultimately had a happy ending, was Capri Holdings. We have discussed Capri many times with you before, most recently at "Meet the Managers" conference, so I will not elaborate on the investment case in much detail.

An example of an investment case that initially moved against us, but ultimately had a happy ending, was Capri Holdings

In a nutshell

Capri is the owner of the Michael Kors (by far the largest contributor), Versace and Jimmy Choo fashion brands. The main reasons we liked Capri were that 1) Michael Kors appeared to be emerging successfully from a multi-year restructuring, 2) Versace's annual sales, of a mere $500mn due to under-investment for a decade by its erstwhile private equity owners, could grow to $2bn (per management guidance) or more (Prada's annual sales are $4.2bn) and 3) it traded on 6X earnings.

Unfortunately, our decision to buy Capri couldn't have been more poorly timed. We built our initial stake at an average share price of $38 per share only to watch it collapse to below $8 during Covid. At that time, people were not only concerned about a decline its sales but also Capri's balance sheet, as it had taken on a significant amount of debt to acquire Versace.

Fortunately, our decision to own Capri ultimately proved to be the correct one as Tapestry, a competitor of Capri and owner of the Coach brand, acquired the company at a valuation of $57 per share, a price which we believe still undervalues Capri tremendously. The deal was announced on the 10th of August 2023.

Let me take you through the mechanics of the deal and explain why having taken our profits on Capri (acquiree), we decided to build a new position in Tapestry (acquiror).

The mechanics of the deal

Tapestry bought Capri for an equity value of $6.8bn which equated to a (historic) PE of roughly 10X. This was a laughably low buyout premium as these were levels that Capri had itself traded on in the not-so-distant past. Tapestry was thus taking advantage of two (recently poor) quarterly earnings releases from Capri, which saw temporary dips in its share price, to take it out on the cheap.

Tapestry itself was cheap, trading on a PE ratio of 10X prior to the announcement of the deal. This was a multiple that was more than fair, although it was higher than the multiple that Capri had drifted towards prior to the announcement of the deal.

Tapestry, a competitor of Capri and owner of the Coach brand, acquired the company at a valuation of $57 per share.

In addition, there was to be limited dilution to Tapestry shareholders from the deal, because Tapestry was trading on 10X earnings and paying 10X earnings for Capri. All the synergies from the deal would thus accrue to Tapestry shareholders for free. These were estimated at the time to be $200mn per annum, or $2bn in today's value (applying the same multiple of 10X). We also believe the likelihood of Tapestry achieving these synergies is high.

Finally, Tapestry's management was generally held in higher regard than Capri's management, so we were getting a boost in management quality as well.

What happened on the day? The Tapestry share price fell 15%. For all the reasons I have outlined above, we did not feel that this was justified.

What Tapestry actually paid for Capri?

- Price paid $6.8bn
- Less: today's value of synergies ($2bn)
- Less: fall in Tapestry's market capitalization on the announcement of the deal ($1.5bn)
- Total: $3.3bn

Capri's adjusted earnings for 2023 were $657mn, which equates to a PE of 5X. To place this number in context, the US market as a whole has traded on an average PE of 15X over the last 50 years, even though the returns of the average company in the US were below that of Capri, and average cash flow conversion was lower as well.

Capri, despite some setbacks initially, proved to be an excellent investment for your fund. Post the Capri-Tapestry deal, we similarly expect Tapestry to be an excellent investment. We can't promise that it will be plain sailing, but ultimately the reward will be worth any temporary setbacks.

In Memory of Bruce Anderson

Our friend and colleague, Bruce Anderson, passed away in early October, after a valiant fight against cancer. Ever the optimist, Bruce was in and out of the office throughout his illness, always upbeat, eternally cheerful. A surfer, avid mountain bike rider, paddler and family man, Bruce achieved so much in his lifetime, not least of which was founding the International School in his home suburb of Hout Bay. His wonderful sense of humour and wit could be appreciated in 'The Monthly Observer' emails he sent to his clients, and as valuable contributor to our Telescope. He had been a part of the Flagship family for 13 years and will be greatly missed.

Bruce graduated from UCT with a BCom in 1976 and qualified as a CA(SA) in 1981 following articles with Arthur Young in Cape Town. He spent 4 years at Irvin & Johnson as a Financial Controller and then joined Fairheads Trust as Portfolio Manager in 1986. In his 20 years with Fairheads he managed a variety of funds including segregated pension and provident funds, various unit trusts, an international fund (incorporating a composite hybrid fund of funds and direct equity mandate) as well as segregated portfolio's for high-net-worth clients. Bruce was a director of Fairheads Holdings, Fairheads Trust and Fairheads Asset Managers. In this time Bruce gained extensive experience across all asset classes and Fairheads Asset Managers twice headed the Alexander Forbes Manager Watch survey of retirement fund managers. In 2007 Fairheads disposed of their interest in Fairheads Asset Managers. Bruce remained with the company as a director and filled a number of roles including CIO and CEO. While at Flagship, Bruce managed segregated portfolio services to high-net-worth clients.

Pictured below, to the right of Winston, Bruce's contribution to the culture at Flagship will be felt for years to come.

In conclusion

We write these Telescopes so that our investors know what it is we are doing, and why we are doing it. For many of you, we are the caretakers of your global investments, and we would like to use this opportunity to thank you for the trust you place in us, and emphasize how deeply committed we are to the responsibility you have placed in our hands.

We believe it is of the utmost importance that all clients feel a true sense of the word “Partnership” in how we are aligned. Our portfolio management team reflects this with significant personal investments in the Flagship strategies.

Flagship funds own a selection of businesses that we believe to be of unusually high quality, and will prove to be financially resilient whatever the prospects of the global economy.

We expect the value of these businesses to rise at an attractive rate over the coming years, and that owning these businesses at a discount to what they are worth will make an additional contribution to your returns.

While we believe that Flagship funds will continue to outperform over longer-term periods, there will inevitably be shorter-term periods over which our funds will not outperform. This is the nature of markets – one’s alpha (or excess performance relative to one’s benchmark) is lumpy and doesn’t accrue in a straight line.

Warm Regards,

Kyle and the Flagship Global Team

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