October 2021

Dear Investor

THIRD QUARTER OF 2021

A recent reading of the old Nomad Partnership letters reminded us of the idea of an equity yield curve. As Nick Sleep writes in 2006, "… *in brief, the equity yield curve is a concept that argues that patience has a value, and that returns increase with time in the equity market as they do on a normal bond market yield curve. In the bond market the higher yield is there to compensate for the increase in risk that the principal will not be repaid, or that the principal may be devalued by inflation. That is not how it works in the equity market: in our opinion business outcomes can be more predictable several years out than they are in the near term*".[1]

We think that we are experiencing a similar situation in several of your holdings today, where we are excited about the long-term opportunity in the companies, but the market is generally focused on and worried about the near-term direction of their share prices. With this in mind, we thought it useful to discuss Micron, one of your semiconductor industry investments. Additionally, we will update you on MEI Pharma and introduce you to a new position, Wix.com.

Micron

We introduced Micron to your portfolio a year ago and discussed the investment case in our third quarter letter of 2020. As a reminder, there are two main types of memory in use today: volatile memory (DRAM) is used in devices to facilitate data processing, while non-volatile (flash) memory is used to store data.

You are undoubtedly aware of the global chip shortage the world is currently experiencing. In general, this shortage refers to several of the older, cheaper chips that have become part of every aspect of our lives. As a result, the completion and sale of cars and many other products are delayed. It's staggering to consider the amount of lost revenue that is caused by a shortage of chips that normally cost only cents or a few dollars each.

The situation is the same for PC manufacturers. The boom in PC demand due to work-from-home and study-from-home trends has now met the same supply chain disruptions seen in other industries. While memory and processors are available, the sale of PCs are now being held back by shortages in other chips. This creates a build-up of inventory at PC manufacturers because they are unable to ship finished goods to customers.

This inventory build-up and subsequent declining prices for memory have always been the canary in the coal mine for the semiconductor industry. What normally happens is that an increase in demand leads to memory price increases, which stimulate investment into more supply. Once demand is satisfied, inventory builds as production continues at the new, higher level – but demand subsides. Selling prices and profits therefore decline for the memory manufacturers, and share prices fall.

This cycle has repeated numerous times in the industry. Why are we less concerned now? We believe that the current inventory build-up and selling price declines are not because of declining end demand, but rather due to the inability of PC manufacturers (similar to automobile, appliance and many other manufacturers) to complete their products and meet the very real demand that remains.

Micron has successfully recovered its technical deficit and is now the technological leader of the industry. The industry has consolidated, with only three producers able to deliver DRAM at scale. There are six manufacturers of flash memory, and this number will reduce as Intel and KIOXIA look to merge with other players. We think DRAM is more attractive than flash and for Micron, DRAM accounts for three quarters of the business.

[1] The letters are available at https://igyfoundation.org.uk/

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Memory remains largely a commodity product and has a cyclical nature as a result. But we see the industry as increasingly rational and standing to benefit from secular growth drivers we have often discussed in other letters. Part of our investment case is that the cycles are expected to be less pronounced and more persistently profitable than in the past. This leads to a more attractive industry to invest in.

Currently, there are two camps of view for Micron and its peers. The first is that this is a normal cycle and that a painful down-cycle in memory prices – like we have always seen – is to be expected. The share price certainly reflects a high likelihood of this happening. Market commentators base their near-term price expectations on trough valuations because that is what has previously happened.

We take a different view. We have conviction in the long-term growth we expect for the memory industry. It has outgrown non-memory semiconductors over the past dozen years, and we expect it to grow even faster over the coming years. We do not expect a severe downturn like the ones we have seen before, as there have been real, positive structural changes to the industry. For that reason, we have not considered selling out of Micron in anticipation of a potential memory winter. In fact, we would most likely be incremental buyers at lower prices if the market sticks to the cyclical playbook of boom-and-bust memory cycles.

MEI Pharma

MEI Pharma is expected to release important data this coming quarter. This data relates to the outcome of a phase 2 clinical trial ('TIDAL') into the efficacy of zandelisib (one of its blood cancer therapies) against follicular lymphoma. As we discussed in a previous letter, MEI has already launched a phase 3 trial ('COASTAL') that would normally only be considered after positive phase 2 results. Additionally, the company has launched further studies into the usefulness of zandelisib against other forms of cancer, including marginal zone, mantle cell and diffuse large B-cell lymphomas.

In the near term, the focus seems to be solely on the outcome of TIDAL in follicular lymphoma and the details of data to be released. We are optimistic about this, but our investment case ultimately revolves around the full application of zandelisib (and the rest of the development pipeline) in blood cancers and other solid tumours.

Wix.com

A new addition to your portfolio this quarter was Wix.com, a US-listed Israeli company that allows users to create and manage their own websites. To build a professional website in the past, you would need to hire a developer with creative and coding knowledge, purchase a domain, subscribe for hosting, and have a professional on call to help with any maintenance or changes. For less tech-savvy businesses, startups and anyone who just wants a landing page for their idea, this process could be prohibitively costly and complex. Wix has solved this problem by enabling users with no coding knowledge to build and launch a fully functional website with little effort.

There are many things to like about the company. The founders are still involved and invested in the business. They have created a product that is wonderfully easy to use. We have tried it and we love it. The business is properly customer-centric, investing in adding new products and services that add value for customers and grow their revenue per user. It is opening up new end markets by adding tools for specific industries, e-commerce functionality, and more sophisticated offerings for developers and agencies. This means it is both growing the pie and taking bigger slices of it. Wix measures everything and has a particularly scientific approach to marketing to maximise bang for buck.

Right now, the company's focus is on growth, with revenue growing at more than 30% a year. This necessitates heavy reinvestment of earnings into research and development, marketing and customer support. Most of its earnings come from predictable, subscription-based revenue and its customer base is sticky. Once you've created your website with Wix, there is little incentive to move it somewhere else. As a result, we believe the economics of the business can be very attractive once it shifts from planting and growth to harvesting returns.

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Conclusion

This letter should be read in conjunction with your quarterly investment statement which contains all the financial information relevant to your account. It continues to be a pleasure and a privilege to manage your capital. As always, we invite you to contact us if there is anything you would like to discuss. We find that there are valuable learnings in portfolio discussions, especially when clients take opposing views.

Your long-term partners

Alex, Catherine, Henno and Paul

Disclaimer

This document is intended for the clients of Capensis Capital (Pty) Ltd. All data provided by Capensis, unless otherwise stated, is current as at 30 September 2021.

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