GROUNDSWELL HOLDINGS

From:

Groundswell Holdings (Pty) Ltd; Rational Expectations (Pty) Ltd; Rozendal Partners (Pty) Ltd and Peter D Wimsey & Associates (Pty) Ltd

Care of:
Groundswell Holdings (Pty) Ltd
15 Rugby Road
Oranjezicht
Cape Town

To:

The Directors
1 Cathedral Piazza
London
SW1E 5BP
United Kingdom

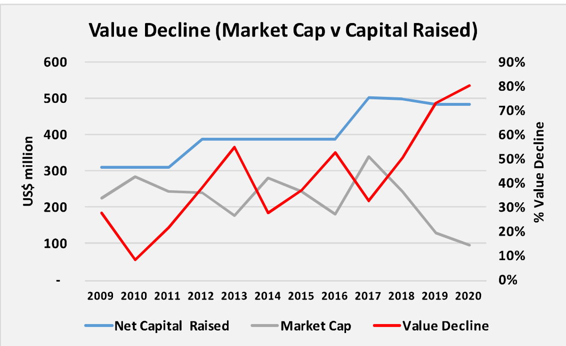
26 October 2020

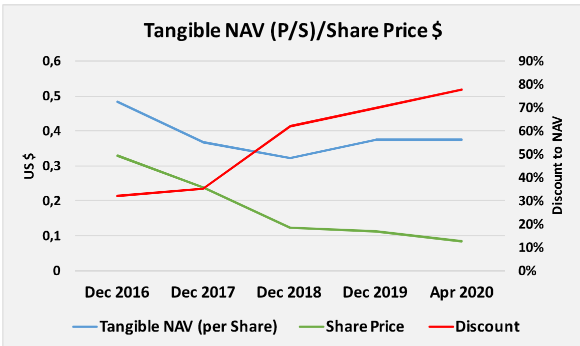
Dear Sirs

<u>Open Letter - Gemfields Group Ltd (GGL)</u>

Thank you for your letter dated 22 September 2020.

Groundswell Holdings, as well as certain other concerned shareholders, commenced a process of engagement with the Board of GGL in April 2020. The main reason for the decision to take an active engagement approach was the continued decline in shareholder value, as highlighted in the charts below:





At $90m, the market capitalisation is a fraction (18%) of the $483m raised from shareholders (net of buybacks) and it has been on a consistent downward trend. The current share price trades at a 78% discount to net asset value (NAV) per share reported to shareholders by the Board.

As part of the engagement process we identified and raised several matters of concern with management and requested additional information to better understand the company. We are grateful to the Board for the extent to which they have been willing to engage with us on these matters.

We expected that the Board, and the Executive Management, would have strong views and beliefs around the business and strategy. That said, such views/beliefs need to stand up to objective scrutiny to the satisfaction of shareholders, on whose behalf the directors are elected to manage the company. Ultimately, despite any disagreements we may have on specific matters, we share the common objective of maximizing the long term value of the company.

In summary, the outcome of our engagement to date is as follows:

Achievements

1. Governance – the Board has accepted the need to address the Articles, and specifically the unusual prohibitive clauses around the change in directors, which depart from the norm for JSE and AIM listed companies. Management has committed to present amended Articles for approval at the 2021 AGM.
2. Remuneration – the Board has committed to implementing a more appropriate Short Term Incentive Scheme based on incentivising excellence on Key Performance Indicator's, rather than the current share price based incentive. The new incentive scheme will be put in place before the end of this year and will apply to the 2020 and 2021 financial years.
3. Non-Core Assets – the Board has agreed to accelerate the sale of non-core assets, including Sedibelo, to bolster cash reserves.

Ongoing Matters/Concerns

1. Head Office/Support costs – we remain of the view that these costs are excessive.
2. Capital Allocation/Fabergé – the engagement has not satisfied our concerns regarding the continued investment in Fabergé.
3. Governance/Accountability – we still have concerns regarding Board accountability and a healthy diversity of views.

The objective of this letter is to explain the reasons for the ongoing concerns above and to respond to the other matters detailed in your letter.

Ongoing Matters/Concerns

1. **Head Office/Support costs and cash preservation**

   Head Office/Support functions and costs are a necessary agency cost between the earnings and cash flows generated by the operational business units and its shareholders. The size and cost of these functions needs to be market related and scaled in line with the size of the underlying operational business units. As a result, these costs were an obvious area of focus when we commenced our engagement.

The challenges presented by Covid-19 have made the importance of running a lean organisation and the need to focus on cash preservation even more critical.

- *Current Head Office/Support costs*

Our initial view was that these costs appeared to be excessively high relative to the size and nature of the company and its underlying business operations. This is an informed view, based on our own actual experience as directors, having managed head office and support functions and costs for a variety of public and private business of similar sizes to GGL (including companies with dual listings on the JSE and AIM).

Following our original letter and discussions with management we have undertaken a detailed review of the GGL Support Costs, including reviewing industry research on the topic and comparing GGL to similarly sized precious gem miners and the mining industry. In this regard, it is important to stress that our review covered consolidated Support/G&A costs (including G&A costs of the mining businesses together with such costs at head office).

Based on this review:

- GGL support costs in 2019 (excluding mining and sales & marketing costs) on a consolidated basis was approximately $30m (R510m).
- Support costs equate to approximately 14% of revenue and 26% of EBITDA. On a comparative basis, against other mining businesses, this should be around 6% of revenue and 12% of EBITDA i.e. $13-15m. This view is based on research including the Shareholders' Gold Council report on G&A costs (September 2019), McKinsey report on G&A costs across multiple market sectors, and G&A costs of similar sized miners (Gem Diamond and Lucara).
- The head office staffing costs are extremely high. Based on information provided by management, the **average** cost per head office employee for the 2019 financial year, excluding the CEO, CFO and 2 MD's, was approximately $130k (R2,2m) before bonus and $160k (R2,65m) after bonus (details are set out in Annexure 1). Given that this includes employees across all levels (junior, mid-level and senior) the average is extremely high. In addition to salary levels, a staff compliment of 36 at head office is high for a company the size of GGL.
- According to management the average bonus for 2019 was 25%. In a UK environment this is high, especially given that many head office employees will have limited influence over Group profitability.

Likely reasons for the high head office/support costs include:

- the complexity of the Group, specifically with the inclusion of Fabergé.
- the location of the head office in London, an expensive city in global terms. During the engagement process management compared London based head office salaries against their estimation of Johannesburg based salaries, where many foreign companies with operations in Africa outsource large parts of their administration costs. Even before any headcount reduction a Johannesburg based head office could deliver a $3,3m saving in head office costs ($2,1m of which relate to staffing costs).

  Your letter refers to this $3,3m saving but for completeness it should be noted that this is an annual saving and not a once-off saving. It is also worth noting that the bulk of the functions at head office are generic support functions that do not require a London base.

➢ *Cash Preservation*

Your letter made reference to the concern raised in our previous letter that only limited head office cost savings had been achieved in response to Covid –19, and our expectation that there should be significant cost reductions on major expense lines, including staffing headcount reductions. Our expectation was specifically in the context of the potential need for a rights issue mentioned in the company announcement.

We were appreciative of the commitment made by the Board in the July announcement that *"should it become clear that hosting auctions by the end of December 2020 is unviable, additional cash maintenance measures will be implemented".* However, since the announcement, there has been no further communication to shareholders that any further cash maintenance measures have been implemented and the Covid-19 situation has deteriorated in recent weeks.

As set out above, our view is that head office/support costs were excessive even before considering the impact of Covid-19. In the context of the current uncertainty, it would be prudent to assume that GGL's revenue will remain depressed for longer than expected and that it could take time to rebuild to the 2019 levels. As is the case with many businesses having to respond to the current epidemic, GGL needs to restructure its cost base in line with lower expected demand and price declines.

Cash preservation and limiting growth in debt is critical and management needs to focus on the cost reduction levers that are within its control to achieve this.

➢ *Marketing Costs*

These costs were excluded from the Head Office/Support costs above and were dealt with as a separate matter.

As a starting point it is important to stress that we are not of the view that this is an unnecessary expense. To the contrary, we understand the importance of creating awareness, interest and demand for coloured gemstones.

However, given the significant annual marketing spend, it is an expense line that justified a closer analysis. As part of this process we have:

- considered the views of/information presented by management.
- researched the amount spent on marketing by other gem miners.
- researched the effectiveness of GGL marketing spend.

In your letter you referred to the view of the Groundswell Consortium that marketing should not be to consumers (b2c) but rather to trade customers (b2b) and that this differs from management's view that marketing to consumers, via its "mine and market" approach, is crucial to ongoing development of the coloured gemstone market.

For the sake of clarity, it is not our view that marketing should be restricted to trade customers (b2b). Where our view differs from management is on the "mine and market" approach and the impact this has on the level of marketing spend. In summary our concerns are:

- *"Mine and market" approach* - using Fabergé as the consumer facing brand to showcase coloured gemstones. It was highlighted in our discussions with management that Fabergé, as the better known brand, raised the profile of coloured gemstones (and Gemfields). This approach has been pursued since 2013 and the cumulative marketing spend (from 2013 to 2019) has been approximately $100m. We have done some research on the brand recognition of Fabergé in order to form a view on its effectiveness as a vehicle to market coloured gemstones to end customers. Based on this research (set out in Annexure 2) there has been limited progress in developing recognition of the Fabergé brand beyond its historic reputation.

- *Marketing Spend/Benchmarks used* – In our discussions, management explained that the marketing spend by luxury brands is used as a benchmark for setting the level of GGL's marketing spend (i.e. 6-8% of annual revenue). It appears that it is due to the inclusion of Fabergé, as part of the "mine and market" approach, that luxury brands are used as the benchmark. However, at its core, GGL is a mining business and Fabergé only contributes 5% to group revenue. As such, our view is that the benchmark for marketing spend should be closer to that spent by mining businesses. Even in years of high spend, the likes of De Beers (the industry leader) have only spent around 3,7% of turnover on marketing, with smaller miners spending much less.

  An indication of the impact of including Fabergé in the "mine and market" approach is evident from the marketing spend by Gemfields PLC before and after the inclusion of

Fabergé i.e. in the 2012 year, prior to its acquisition of Fabergé, the marketing spend of Gemfields PLC as a pure mining company was $1,6m (or 1,94% of turnover), however, in the following year this jumped to $9,8m (or 20% of turnover) and it has remained high since then.

In summary, while we do not discount the need for consumer facing marketing, we question the belief that Fabergé, as part of a "mine and market" approach, is an effective vehicle to achieve this. Firstly, the need to compete against much larger, established and better funded jewellery brands for the mindshare of consumers is very expensive. Secondly, it can result in conflicts/relationship issues as Fabergé competes with jewellery brands that are also customers for coloured gemstones.

Conclusion – Head Office/Support Costs and Cash Preservation

Unfortunately, the engagement process has not resolved concerns raised. We remain of the view that head office/support costs (including marketing spend) are too high and that more needs to be done to preserve cash. Furthermore, the visible actions of the Board in response to the Covid-19 crisis appear to be based on a short term view i.e. that the market will return to normal in the near term and that structural changes are complicated and could result in short term costs.

We have had experience in effecting similar structural changes and accept that it is not a simple process and will result in short term costs. However, our focus is on the long-term impact that these high costs have on the value of the company, the likely slow return to historic past revenue levels and the urgent short term need to preserve the company's limited cash resources. The company's strategy/response should be to create a lean support cost structure based on a conservative view regarding future revenue.

2. **Fabergé (Capital Allocation)**

As set out in your letter, our recommendation was that Fabergé should be placed on care and maintenance with immediate effect, with costs cut back aggressively pending a sale to a third party, but noting that a sale may take time to achieve in the current environment.

We have engaged with management to try and understand the reasons for the continued investment in Fabergé. The engagement has not provided us with any objective information that supports the continued allocation of capital to the business. We remain unconvinced that continued investment in Fabergé makes commercial sense for the following reasons:

- the investment in Fabergé since acquisition has been approximately $230m (excluding joint marketing costs at head office level).
- the 2019 revenue was only 10% of the target set in 2012, and lower than 2016 revenue.

- the business is still cash negative on an annual basis, with no positive cash contribution expected in the near term.
- despite significant marketing spend minimal brand recognition has been achieved (as set out in Annexure 2).
- there are questions around the jewellery design meeting consumer interest i.e. Fabergé has incurred inventory write-offs of $10,8m over just the last 3 years. There is potential for further inventory write-offs, with $23,7m of the inventory (per the latest Interim Report) being regarded as "showpiece" and not required for operations.

In light of the above, it is impossible, on any objective basis, to justify the continued belief by management that they have the ability to develop Fabergé as a luxury brand as originally intended. The Group lacks both the balance sheet and the market understanding (based on revenue and brand recognition established to date) to develop a luxury brand.

Furthermore, it is our view, that Fabergé adds to Group complexity and additional support costs to head office. From the current share price (and share price pre-Covid-19) it is probable that shareholders are discounting the company's value by the expected ongoing Fabergé cash drain.

As a result, we remain of the view that the continued investment in Fabergé is a poor capital allocation decision and potentially motivated by a sunk cost fallacy. Fabergé should be treated as non-core, further investment should be limited, and an exit plan should be put in place to maximise shareholder value.

3. **<u>Governance/Accountability</u>**

In your letter you dealt with the issue of the proposed appointment of Mr Marshall-Smith to the vacant Board seat and well as our comments regarding the diversity of views on the Board. On the day of your letter Mr Marshall-Smith was informed that the Board will not be considering him for the 8th director position, without any specific reasons given or engagement with him on any potential issues identified by GGL relating to his candidacy.

Our response to these matters is set out below:

➢ *<u>Appointment of Mr Marshall-Smith</u>*

The recommended appointment of Mr Marshall-Smith appears to be the only instance in GGL's history (since at least 2013) where a candidate, enjoying a sizeable level of support, has been proposed by shareholders. At the time of our letter we had received written and/or verbal responses indicating support for his appointment from 41,9% and from more than 20 shareholders (including: Titan, OVMK, Value Partners, Ninety-One, Rational Expectations and Ellerines). Since our letter Old Mutual have also indicated their support of Mr Marshall-Smith's candidacy bring total support to 48,4%.

Your letter has highlighted concerns regarding Mr Marshall-Smith's independence and objectivity as reasons for the Board's decision, however, no opportunity has been afforded to him, or any of the proposing shareholders, to engage with the Nomad or the Board on these perceived concerns before making a decision.

On the matter of objectivity, Mr Marshall-Smith has led the engagement process between GGL and many concerned shareholders. As highlighted earlier in this letter, he has raised many important matters that the Board has agreed to address. Inevitably there are matters on which there are differences in opinion, however, the views or comments made by Mr Marshall-Smith during the process, specifically to the extent that these differ from those of the Board, is not an indication of the lack of objectivity as indicated in your letter, but rather a healthy diversity of views as expected by shareholders.

The way this matter has been dealt with goes to one of our core concerns i.e. that the restrictive clauses in the Articles, regarding the appointment of directors, results in a lack of accountability. Historically all appointments have been made by the Board, mostly between AGM's, and it is difficult not to reach the conclusion that the Board views appointments as its exclusive right.

We are disappointed that the Board has indicated that it will not support the recommended appointment.

➢ *Board Diversity*

In your letter you invited us to share the reasons for our questioning the diversity of views on the Board. Obviously, without being party to Board meetings, our views are based on actions visible from the outside. Furthermore, our comments in this regard do not in any way question the best intentions of any current members of the Board.

Our view on this point is based on the expectation that, fundamental to a healthy Board, is a culture of challenging the Executive Management and protecting shareholders' interests. Visible signs of this include:

- decision making which is objectively logical;
- cost control/efficiency in protecting company finances;
- proactivity in action, rather than only acting on pressure from shareholders;
- a clear understanding of accountability to shareholders.

The following matters are cause for concern:

- *Capital allocation decisions (specifically with regard to Fabergé)* – the continued belief that this business justifies continued investment, or that GGL has the balance sheet to successfully develop a luxury brand of scale, raises serious concerns around objectivity.
- *Head Office/Support Costs* – it is difficult to accept that these costs, which are excessive,

have been challenged by the Board.

- *Unlocking Value/Discount to NAV* – we raised this matter at the latest AGM to get the Board's view of the reasons for the low share value and high discount to NAV, and to understand what action was being taken to address this. In summary, the response was as follows:

  - *Discount* – the discount was largely attributed to historic factors i.e. Pallinghurst's structure/objectives, some bad press and failure to pay dividends (deliver returns).
  - *Strategies to reduce the discount* – the Board believes they have been addressing the issues facing the company i.e. have listed on AIM, bought back shares and are focused on putting 'runs on the board'.

  While these may be contributing factors, we do not believe they are the major factors for the share performance i.e. the historic factors have largely been addressed and the mining businesses have performed well over the last 3 years, however, the share price has continued to decline.

  Clearly there are other factors affecting the share price/company value, including the matters of concern we've set out above. Some of the issues cannot be controlled by the Board and executive management, however, those that we have highlighted can. Challenging the reasons for the poor share performance and the action to be taken requires different views/ideas, which to date is not evident.

- *Remuneration* – the current board has to date not been able to come up with any appropriate changes to the remuneration approach despite more than 25% of shareholders voting against GGL's remuneration policy and implementation report at all of the last 3 annual general meetings.

- *Accountability to shareholders* - as uncomfortable as it may be for the Board to hear, there is a perception held by many shareholders and potential shareholders that the company is managed for the benefit of management. This was clearly more so before the management agreement was cancelled, however, responses we received during the engagement process raise legitimate questions around the attitude of the Board regarding accountability to shareholders.

  For example, on amending the threshold required for a change of directors in the Articles, the CEO responded that "*it would be imprudent, in the middle of the COVID19 crisis when share prices are low, to make GGL more vulnerable to hostile takeovers (as PRL/GGL experienced in 2017) by reducing the thresholds for appointing / removing directors".*

  With respect, the changes make GGL as vulnerable to hostile takeovers as any other normal listed company and retaining the high threshold only really serves to protect the positions of existing directors. We appreciate the Board is making our proposed changes, however, we can see no legitimate reason for the delay until the next AGM.

4. Other Matters

The other matters in your letter were:

➢ *Dropping GGL's AIM Listing*

In the shareholder-management interaction session on 27 August 2020, we did question the value added by the AIM listing. The AIM listing has provided very little additional liquidity, increased regulatory complexity together with additional associated costs (fees and staffing required to manage this complexity) and no evidenced tangible benefits.

We remain unconvinced of the long-term value of the AIM listing versus the associated costs thereof, particularly while the key issues affecting the attractiveness of the share set out above have not been addressed. **That said, we have not raised this as an issue requiring any immediate action.**

➢ *Rights Issue*

Our comments regarding the possibility of a rights issue were based on:

- comments in GGL's communications to shareholders that a rights issue may be required.
- the publicly available cashflow information and the operating costs at the time.
- the debt facilities at the time (the additional $15m facility had not yet been secured).
- the expectation that the mining operations would recommence sooner than now expected.

We are pleased that this matter has now been clarified and that the Board is confident that there is sufficient funding to last for at least 8 months (until Q3 2021 per the recent Interim Report). However, we stress the point above regarding cash preservation and limiting the level of new debt incurred.

➢ *EGM/Change in threshold for appointment of Directors*

We acknowledge and respect that shareholders will hold different views regarding the proposed change and the timing thereof. We remain of the view that had the amendments we requested been put to shareholders at this year's AGM as we requested, they would have been approved.

Yours faithfully

William Marshall-Smith
William Marshall-Smith (Oct 26, 2020 11:44 GMT+2)

Groundswell Holdings (Pty) Ltd
Director

Johan le Roux (Oct 26, 2020 11:48 GMT+2)

Rational Expectations (Pty) Ltd
Director

Wilhelm Hertzog (Oct 26, 2020 15:38 GMT+2)

Rozendal Partners (Pty) Ltd
Director

Diderik J Otto
Diderik J Otto (Oct 26, 2020 11:57 GMT+2)

Peter D Wimsey & Associates (Pty) Ltd
Director

Annexure 1 – Head Office Staffing Costs

The information below is based on information provided by Mr D Lovett.

R/$ = 16,50	Total Salary $ $000's	Bonus $ $000's	Total Comp. $ $000's	# of Heads	Ave Salary $ $000's	Ave Salary R R000's	Ave Comp. S $000's	Ave Comp. R R000's
CEO								
CFO								
2 MD's								
Finance, Tax, Reporting, MIS, IR								
Bus Dev, New Projects, Admin etc								
IT systems,support, websites & G-Trac								
Legal, Regulatory & Compliance								
Marketing & Comms								
HR								
Total	5 799	1 321	7 120	36	161	2 658	198	3 263
Excl CEO, CFO & 2 MD's					133	2 196	160	2 646

Text shown in red in this table has been inserted by Gemfields. Gemfields has redacted the department-level data in order to protect personal data and prevent disclosure, including to other Gemfields team members, of the remuneration levels of individuals who might otherwise be identifiable. Remuneration paid to the CEO and CFO is in the public domain and is set out in the annual report and in the historic summary available here.

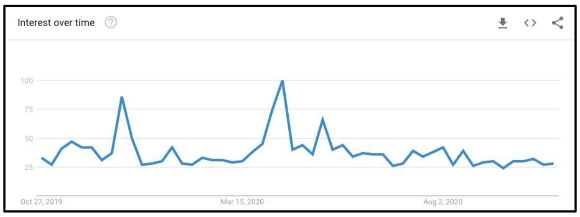
The totals shown in red below have been added by Gemfields for completeness.

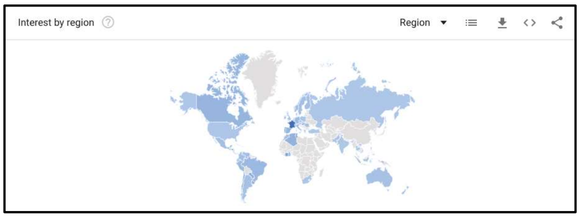
Annexure 2 – Fabergé Brand Awareness

Google Trends

In the marketing presentation by management reference was made to Google Trends, so more analysis was done on the brand using this tool for the past 12 months as follows:

1. Search simply on the term 'Fabergé' - result was:



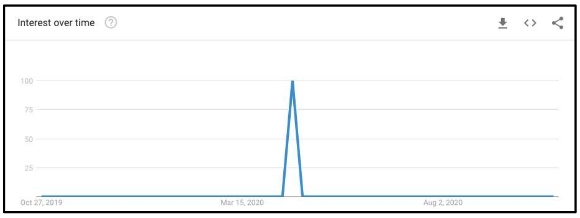


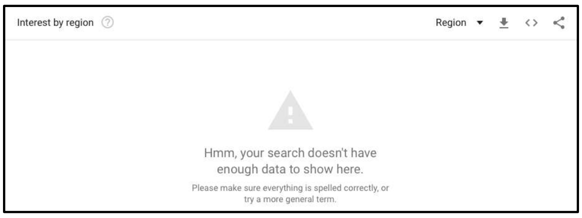
This appears to suggest fairly widespread interest, however, when looking at what the search was related to it is clear this was mainly around history and the eggs as follows:

Related queries (Top)		
1	oeuf fabergé	100
2	oeuf de fabergé	74
3	fabergé egg	32
4	faberge	29
5	ovo fabergé	27

Related queries (Top)		
6	oeuf fabergé prix	27
7	fabergé eggs	20
8	huevo de fabergé	19
9	prix oeuf de fabergé	19
10	huevos fabergé	19

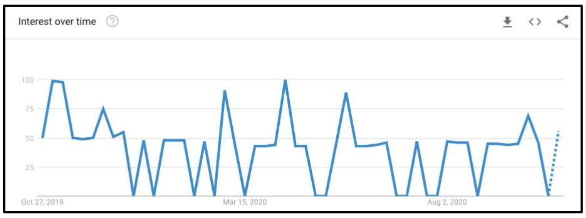
2. A more refined search, using the term 'Fabergé Jewellery", was used – result was very little interest and too little data to show interest by region as follows:

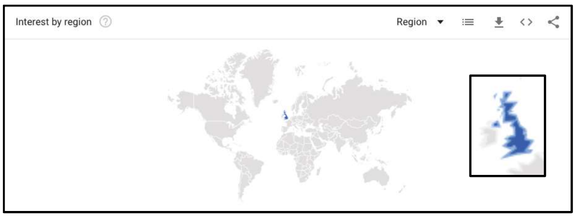




This search was repeated using the American spelling i.e. 'Fabergé Jewelery", and the result was too little information to show interest over time or interest by region.

In order to take into account the possibility that the search was for Faberge, without the acute, the search was repeated for "Faberge Jewellery" – the result was as follows:



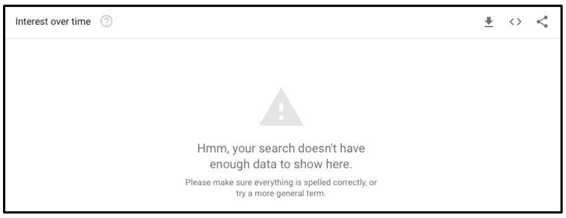


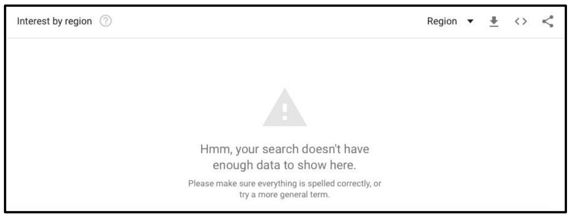
The interest in the term "Faberge Jewellery" (without the acute) is larger, however the only region it is showing up is in the UK, which is where the company is based, and not where customers in the major markets are located.

Again this was repeated using the American spelling i.e. Faberge Jewelery and the result was too little information to show interest over time or interest by region.

3. A similar search was performed using the terms 'Fabergé Watches" and "Faberge Watches". The results were as follows:

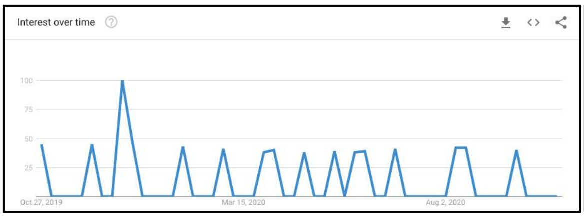
'Fabergé Watches"

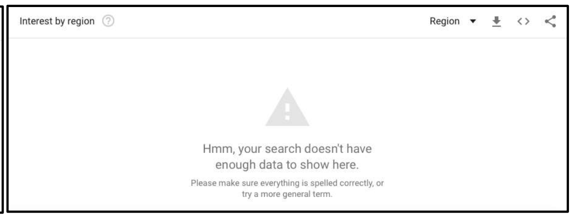




Faberge Watches

While "Faberge Watches" (without the acute) has had more interest that "Fabergé Watches", in both instances there is too little data to provide information regarding interest by region.



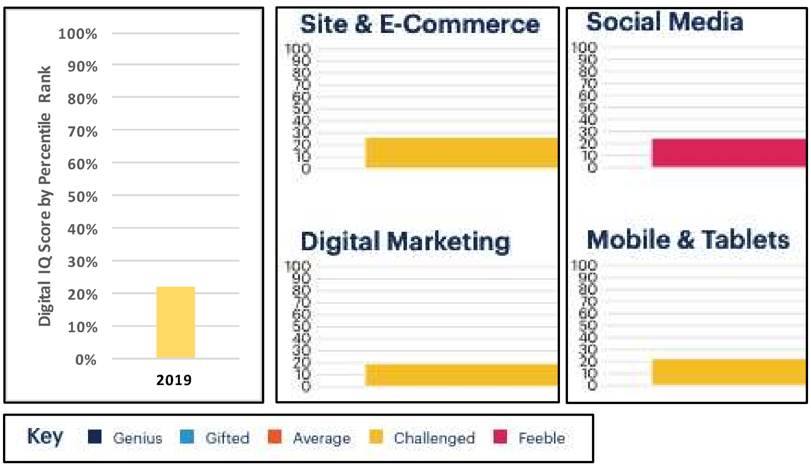


Google trends – Conclusions

1. While there is fairly widespread interest in a search of Fabergé, it appears that this interest is around the history and specifically the Fabergé eggs.
2. There is very little interest in searches on Fabergé/Faberge Jewellery or Fabergé/Faberge Watches. In all cases the interest was too low to provide data by region.
3. It does not appear from this exercise that interest in the Fabergé brand, other than its history, has been particularly well developed.

Gartner (Digital IQ Index: Watches & Jewelry Global 2019 Report)

Information, with regard to Fabergé was as follows:



Based on the report Fabergé's digital positioning is pretty poor – overall it's presence is ranked as challenged and its social media position is rated as "feeble".
[See : https://www.gartner.com/en/marketing/research/data-tools/brand-search?brand_id=671&study_id=067ad389-a2fc-4cbe-b43a-87067e53b60c]

Gartner Digital IQ – Conclusions

Digital positioning is becoming increasingly important for luxury jewellery brands and based on the Gartners report Fabergé is lagging far behind.

Brand Awareness - Overall Conclusions

The review above is based on limited desktop research, however, the results from Google Trends, given their coverage, provides a reasonable indication that Fabergé (as relaunched rather than historically) really does not enjoy strong interest/brand identity.

While it is obviously 'unfair' to compare the Fabergé brand against larger luxury jewellery brands, who probably have significantly bigger marketing budgets, it really highlights the impossibility facing GGL in trying to establish a competitive luxury brand.