Mutoro Group Partners, LP

Second Quarter 2018 Letter

August 8, 2018

"A man who examines the saddle and bridle and not the animal itself when he is out to buy a horse is a fool; similarly, only an absolute fool values a man according to his clothes, or according to his social position, which after all is only something that we wear like clothing." – Seneca

Dear Partner,

By now you might be noticing a pattern. A pattern regarding the types of businesses we seek to add to our portfolio. These businesses are typically (a) highly cash generative, (b) the dominant or key player in a focused industry (whether large or small), and (c) priced such that the expected value of a successful outcome outweighs the probability and magnitude of downside risks. In May we made an investment in a business we will call "Company G"; I think it fits this pattern well. Because we put 10% of our portfolio into this business, it is worth understanding.

Company G is a holding company for several leading digital brands that sell online recurring subscriptions in what is a relatively nascent market but an evergreen field of human activity. To understand this company better and our investment, it might be useful to appraise it through three different perspectives, typically not captured in the one-page theses on our holdings attached in the addenda to these letters. Let us analyze Company G through the vantages of Finance, Strategy, and Products. What we hope to find from looking at all three perspectives is what they suggest about the company's ability to sustain and grow free cash flow, the key attribute of the investment value of any asset.

Finance

In trying to understand a business's finances, it is important to consider all three core financial statements and not make the mistake of focusing solely on one. To this end, we will consider what made this company attractive to us from its income statement, balance sheet, and cash flow statement.

In Company G's annual results for 2014, 2015, 2016, and 2017, its revenue grew 6%, 9%, 23%, and 19%. Minus that slight dip in growth rate in 2017, Company G had over the last four years been growing its revenue at an increasing rate. When we look at its quarterly results in 2018 so far, we see more of the same. Both Q1 and Q2 2018 revenue grew 36% year-over-year, as subscribers and annual revenue per user also rose. But we should not assess revenue growth in a vacuum, as it can come about easily if management does not also have the compulsion to generate profits. Happily, Company G had also been increasing operating margins, which from 2014 to 2017 came in at 8%, 15%, 16%, and 27%. Its Q1 and Q2 2018 margins were even better, rising to 28% and 36%.

Looking at its balance sheet and cash flow statement, we see more of the same strong financial performance. From 2015 through Q2 2018, as the company's cash balances and free cash flow grew because of its rising operating leverage, its net financial leverage declined from 4.1x to 1.6x. Indeed, the company was so cash-generative that in the first half of this year, it had already generated 80% of the free cash flow it earned in the entirety of 2017. Suffice to say that if you are relatively new to business analysis from a financial perspective, I can assure you that all of the above is not just strong but incredibly impressive. But this information is in itself not useful for making a decision about whether to buy Company G and its basket of software assets. It is akin to attending many open houses in a desirable neighborhood and getting a sense for which homes have the best curb appeal and structure but not knowing which one to buy or why. Let us turn to the competitive strategy and product offerings of Company G to improve our assessment.

Strategy

There are two things would-be entrepreneurial competitors to Company G might tell themselves to inspire confidence in competing with Company G: (1) Barriers to entry are low in this space, and it is relatively cheap to create a product that competes with each of Company G's own, and (2) Customer switching costs are low as well, and as such, should they want to, users would have no issue joining a new platform over Company G's. However, one crucial problem for any new entrepreneurial efforts in this space is that while customer switching costs and barriers to entry low, barriers to scale and profit are major.

Company G has over several years built up millions of users on its software applications and derives its revenue from selling a subgroup of those users recurring subscriptions to higher-value offerings on its applications. It has rarely made large acquisitions of competitors. As a result, it has as far back as we can gather from its public financials been a company that generates significant free cash flow from its operations. This is not typical for companies in this space. As happened with Company G's own platforms, it takes several years to gather users through significant marketing spend and a freemium model of service that offers a free tier of activity before pulling different behavioral levers to convince some users to switch to paid tiers. And this is not assured to work. Many competing standalone brands launch regularly yet never take off because users never join or users join but leave because they do not find a compelling or differentiated value proposition in that specific application or its paid tiers.

To generate profits in its various applications, Company G has two things going for it to strategically counter low switching costs and barriers to entry. Because customers have no limitations on how many products they can use and switching attention between any is easy, Company G owns at least a dozen large, international products servicing the different interests, preferences, and demographics within the marketplace. This portfolio approach comes from its early success in the field and is unique among its competitors. It has allowed Company G to experiment with different business models and brands and is an important reason the company was able to ignite growth in recent years. And because consumers themselves seek a portfolio approach to the applications they use, it means that a deeper-pocketed peer, able to invest years of marketing spend to compete, would still be at a disadvantage trying to offer simply one product to compete with the many successful products Company G offers and that different consumers value in different ways.

Product

Because Company G has been in this market since its earliest days, it has an advantage over newer, fast-follower peers: Company G is essentially operating several digital social networks, and like the best social networks, it benefits from network economics. This means the larger its networks grow, the more valuable it becomes to its existing users as well as new users and the cheaper it becomes to the company for its network to expand. (This is why marketing spend for the company has been declining as a percentage of revenue and operating margins have been growing.) Thankfully for Company G, it has the most users of any company in the world in this particular niche. I hesitate to say that it dominates its industry, though, as it is still defining this growing market and educating its customers on the benefits of its offerings whilst attracting new ones who have never used it or its competitors' products.

It should not come as a surprise that one of the company's key product attributes to its users could also be considered one of its strategic advantages, namely that it has substantial networks. It suggests a happy alignment between the inherent customer value of its products and the inherent value of the business itself. Company G is not just creating value for its customers but is also able to capture a lot of that value. What makes this all the more attractive for both users and the business is that the content that users join the network for is essentially each other. With user-generated content and word-of-mouth advertising from existing to new users, it is no surprise that Company G's product offerings have gotten better through the years, and its revenue and margins have been accelerating.

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So how do we know if this good house is a good buy? I have long been interested in Company G given its stable of highly profitable and high margin brands. But my interest spiked this May when a larger company announced it was directly entering the same business as Company G. The share price of Company G immediately fell 22%. A discounted cash flow valuation I performed suggested to me its investment value was well above this new lower price. The marginal participant in the market clearly focused more on threats of the new competitor than the tremendous operational success Company G has shown and is likely to show. Unlike its new competitor, which is a dominant player in a separate and larger field, Company G's entire existence is predicated on making the right decisions in the specific industry it helped to create. For that reason, I think Company G will be more motivated to do whatever it takes to grow the substantial moat it has already created around its portfolio of assets. Over time I believe we will be happy to have built a position in it after such an unexpectedly negative repricing of its shares.

I would like to now briefly review the rest of our portfolio. In aggregate, we finished the first half of 2018 down 0.99% net of fees and expenses. The table below summarizes our portfolio composition at quarter end. After quarter end, we also made an investment of roughly 10% of our portfolio in a Company H, which is not reflected in our portfolio composition below:

Cash and Cash Equivalents	76.5%
U.S. Public Equities	23.5%
Total Portfolio	100.0%

Table 2. Portfolio Composition

I am extremely grateful for your partnership and every day am thankful for the trust, patience, and confidence you have placed in me with your capital. I am always available for any questions or comments you may have.

Sincerely,

Godfrey M. Bakuli

Godfrey M. Bakuli
Managing Partner