July 28, 2015

Dear Investor:

The Global Moat Composite rose 1.3% during the second quarter, versus a 0.3% gain in the MSCI All-Country World Index (ACWI).[1] Results for other time periods are in the table below, in USD and in local currency.

	Year to Date (6/30/2015)	Trailing Twelve Months	Since Inception (4/1/2014)
Global Moat Composite (USD)	4.5%	6.3%	6.7%
MSCI ACWI (USD)	3.0%	1.2%	6.5%
Global Moat Composite (local)	7.8%	16.6%	16.9%
MSCI ACWI (local)	4.6%	8.7%	14.9%

We put some cash to work last quarter, adding to our Silverlake Axis position and initiating positions in Just Eat PLC and Linx SA. On the research front, we traveled to London, Milan, Brazil, and South Africa to visit companies, uncovering some interesting nuggets that we'll discuss later in this letter. Our research pipeline is in good shape, and we're optimistic that we'll be able to continue whittling down our cash balance as the year progresses. It goes without saying that some equity market weakness would help on this front, but we are mindful of being careful what you wish for when it comes to market movements.

Portfolio Update: Silverlake Axis

In early June, a Singapore-based blog published a report questioning the quality of Silverlake's reported financial results, sending the shares down about 25% over a few trading days. We contacted the author of the report, determined that his opinions were based on an incomplete understanding of the company, and took advantage of the pullback to increase our position.

The background to the blog post is Silverlake's rather complex history. Silverlake Axis is 65% owned by a private company controlled by founder Goh Peng Ooi. When it originally listed in 2003, the public piece of Silverlake only performed software installations. The licensing business was transferred from

[1] Individual account returns may differ due to the timing of the initial investment.

the private company to the listed entity in 2006, and the more steady maintenance work was transferred over in 2010. The private company still controls some non-core business lines, accounting for about 20% of Silverlake's total revenue. One can selectively discuss bits and pieces of this history to paint an unsettling picture, which is what the blogger chose to do.

Our diligence has not uncovered any evidence that Goh Peng Ooi has used the company's ownership structure to take advantage of minority shareholders. In fact, minority holders were consulted when the maintenance business was transferred to the listed entity in 2010 to ensure that the transaction was fair to all parties. Moreover, the company's consistent practice of paying out the bulk of free cash flow as dividends is strong collateral evidence of a healthy business, as well as one which allows minority holders to benefit from the company's success *pari passu* with the majority owner.

In sum, we don't think there's anything amiss at Silverlake, and we're excited about the company's future. It remains our largest holding.

Portfolio Addition: Just Eat PLC

We purchased a small position in Just Eat, a UK-based firm that enables online ordering from takeaway restaurants. This may sound like a niche and pedestrian business, but it's actually one with network economics, pricing power, and tremendous operating leverage. Let's look at each of these attributes in turn.

With regard to network economics, users prefer whichever ordering platform has the broadest choice of restaurants, and restaurants want to partner with whichever platform gives access to the largest number of potential customers. While the switching costs for users are not material – it's easy to click over to another app or website – there are significant barriers to success for a rival platform looking to acquire a network of restaurants large enough to entice customers to switch.

Takeaway restaurants are generally small independent entities (especially in the UK), and signing them up one by one is a lengthy and expensive process. So, a potential rival would need time to replicate Just Eat's restaurant network, and during that process Just Eat would be expanding its own network and further improving its value proposition with users. Moreover, Just Eat requires restaurant partners to pay a one-time fee of £699 to cover the cost of onboarding the restaurant to the system – a rival network would either need to ask restaurants to pony up a second entry fee, or would need to absorb the onboarding cost and thus increase the amount of capital required to replicate the network.[2]

Just Eat's pricing power is based on its hugely fragmented customer base – the company works with 46,000 restaurants, 95% of which are independent – and its ability to drive significant volume to its restaurant partners. Although it may seem irrational on the surface for a low-margin restaurant to give up 12% of revenue (Just Eat's current commission rate), the bulk of a restaurant's costs are fixed (rent, power, labor), so incremental orders are highly valuable. Moreover, as takeaway ordering undergoes a channel shift from phone to online, the bargaining power of restaurants decreases even further, since leaving the Just Eat platform could materially reduce a restaurant's order volumes. Most importantly, we have empirical proof: Just Eat raised its UK commission rate from 11% to 12% in 2014 and only lost a handful of its 20,000 UK restaurants. Our discussions with the company indicate that it intends to slowly increase the UK commission rate to 14%-15% over the next several years, and we do not believe this will cause meaningful restaurant attrition.

Finally, Just Eat enjoys tremendous operating leverage, since the costs of running the platform are largely fixed. Gross margins are about 90%, and G&A as a percentage of sales fell about eight percentage points in the U.K. just in 2014. At scale, we estimate incremental drop through margins of 75%.

Given this rosy picture, why did we scale our initial position at just 2.5%? We did so because the shares already discount a reasonable level of success, and because it's difficult to estimate the size of the ultimate market opportunity with a high degree of confidence. We think that a £4.5 price appropriately values a base-case UK opportunity, which we triangulate by estimating the total value of takeaway orders, Just Eat's share of the market, and the company's at-scale commission rate.[3] Upside to our base case would come from success in the UK with restaurants that offer collection (pickup), higher market share in the UK, or success in the company's 13 non-UK markets. Although we currently model an aggressive-sounding 50% market share at scale, it's worth noting that Dominos UK already gets 70% of its orders online – so upside to our 50% market share estimate is plausible if the channel shift for takeaway ordering from phone to online continues apace.

[2] According to Just Eat, the entry fee also ensures that new restaurants are committed to working through any onboarding hiccups and becoming valuable long-term partners. As CFO Mike Wroe puts it, "You value what you pay for."

[3] This estimate is our "sanity check" on a more granular forecast of restaurant partners, order volume, and cost structure.

In sum, our goal is to minimize opportunity cost if Just Eat shares keep going straight up as high order growth translates into meaningful operating leverage. But if Just Eat follows the more typical path of a young business growing at a very fast clip, the shares will be volatile as market participants extrapolate small amounts of new information far into the future. With luck, we will get an opportunity to add substantially to our position at lower prices.

Portfolio Addition: Linx SA

Our second new purchase this past quarter was Linx, a Brazilian company that creates retail management software. Linx ticks many of the boxes we like to see in a software company: an owner-operator mindset, vertical-market specialization, meaningful customer switching costs, high recurring revenue, a growing end market, and disciplined capital allocation. The current gloomy sentiment surrounding Brazil has given us the opportunity to purchase shares at what we believe will prove to be an attractive price.

Linx started out in the mid-eighties writing back-end software for apparel retailers, before more recently expanding via acquisition to other verticals such as gas stations, drugstores, and grocery stores (among others). About 80% of revenue is recurring, typically paid monthly based on annual contracts with built-in adjustments for inflation. Clients renew at a 95%+ rate, and contract values vary based on the number of software modules to which clients subscribe – Linx offers back-end (ERP) and front-end (point of sale, or POS) software, as well as additional services such as e-commerce and mobility solutions.

Linx is currently as large as its next three competitors combined, and our primary research indicates that both local competitors such as Totvs and foreign giants such as SAP & Microsoft have had difficulty successfully penetrating the market for retail software in Brazil. Although there are a number of reasons for Linx's entrenched position, we think the most significant is Brazil's absurdly complex tax system. The World Bank estimates that mid-sized companies in Brazil spend 2,600 hours per year complying with tax regulations (versus 175 hours in the OECD and 370 hours in the rest of Latin America), and Linx estimates that the Brazilian tax code changes every three days. Linx has over twenty employees dedicated solely to ensuring that the company's software is compliant with federal, state, and local tax codes.

In addition to complying with the relevant regulations, tax software in Brazil must also be formally approved at the state level – and given that Brazil has 27 states, these approvals are a further deterrent to potential competitors. Finally, the Brazilian government is tightening reporting standards for retail transactions in Brazil by mandating that transactions be reported electronically, starting in 2015. These new requirements enhance Linx's competitive advantage as the leading incumbent, and should also increase demand at the margin by encouraging retailers to invest in retail management software.

We think there are three significant long-term drivers of value creation for Linx:

Retail Formalization: Although one might think that purchasing Linx shares is akin to betting on the Brazilian consumer, it's important to look more broadly at the development of the Brazilian retail sector. We're cognizant of the rapid increase in domestic credit in Brazil as a percentage of GDP over the past decade, and we did not buy Linx because we're betting on a renewed credit boom. Instead, we are assuming that the well-established trend of retail formalization in emerging markets continues to play out in Brazil as it has elsewhere. As economies mature, consumers shift purchasing habits from informal tuck shops or bodegas to modern retail outlets that typically offer a better experience. [4] Governments are highly incented to encourage this shift, since redirecting spending from the informal to formal sectors increases revenue by expanding the tax base. And in the case of Brazil, which has a relatively "strong" state as emerging markets go, the push to collect taxes will encourage retailers who have not yet implemented retail management software to do so sooner than later.

Disciplined Acquisitions: Since receiving capital infusions in 2009 and 2011, Linx has spent R500m on 20 acquisitions, adding R180m in revenue and paying an average of 2.8x sales. Acquisitions have typically been used to enter new retail verticals, such as drugstores, gas stations, and home improvement stores. Linx buys companies with either the best industry-specific software or (less commonly) the best distribution channel in an industry, and works with the acquired company to expand both the reach and the quality of the offering. Acquired companies typically have margins about ½ of Linx's more mature business lines, and Linx aims to bring their margins in line with its own within 3-5 years. We've spoken at length with Linx's CEO about the company's process for acquisitions, which he summed up as, "We don't buy companies that the guy needs to sell." Linx is focused on buying businesses much like its own – strong margins, the potential to scale, and high levels of recurring revenue.

[4] We have seen this movie before in South Africa, which currently has a retail sector that looks more like a developed market in terms of formalization and concentration in the hands of a relatively small number of players. As a result, retail investments in SA have been home runs over the past 15 years, despite fairly tepid (3.5% annualized) rates of growth in overall consumer spending.

Margin Expansion: With only a 17% EBIT margin, Linx is currently less profitable than many other vertical market software companies. This reflects the impact of the company's recent acquisitions, given the significantly lower profitability of acquired businesses relative to "legacy Linx." However, as recently acquired companies are brought up to group level margins over the next few years, and as acquired revenue shrinks as a percentage of overall revenue over the longer term, we think Linx's operating margins will expand significantly. Operating margins were 26% in 2010 prior to the recent spate of acquisitions, and management has indicated to us that a 30% margin is a reasonable target over the next decade. Our current mid-sixties (BRL) valuation estimate assumes that margins peak at 26%, so a 30% at-scale margin would be materially additive to our valuation estimate.

Research Update: South Africa

We visited South Africa in mid-June to attend the PSG Group annual meeting, and to meet with a number of management teams. South Africa is an interesting place, to say the least. Average corporate returns on capital are some of the highest in the world, and we're constantly impressed by the caliber of many South African managers. On the flip side, the country can't manage to keep the lights on (literally), unemployment is nearing 25%, and the ANC has not exactly covered itself in glory as a governing party. It's not an easy place to do business.

Howden Africa Holdings has experienced these difficulties first hand, as South Africa's fiscally-strapped power monopoly (Eskom) has cut back on maintenance spending and pushed its suppliers for price concessions. Moreover, Howden has been attempting for a couple of years to arrange a deal that will satisfy the country's black economic empowerment (BEE) regulations, but has been unable to do so.[5] Given its status as an important supplier to a major state-owned entity – Eskom – and given that Eskom is as much a political football in SA as it is a provider of electricity, we suspect that Howden has become stuck between Eskom and its U.S.-listed majority owner, Colfax. (The fact that the New York and Johannesburg stock exchanges have to weigh in as well doesn't make things any simpler.)

We met with Howden's CFO and CEO at their main factory on the outskirts of Johannesburg, and came away with a better understanding of how the company is addressing these challenges as well as a better appreciation for the potential to improve an already-lean enterprise using some of Colfax's tested management techniques. Coming up with a BEE plan that satisfies a number of entities with very different interests may take some time, but Howden seems to be willing to be patient in order to strike a

[5] Businesses in SA must comply with a set of thresholds regarding ownership, management, procurement, and so forth, which are designed to help redress the inequalities of Apartheid.

good deal with a good partner. With regard to Eskom, we came away from the meeting assured that Howden's competitive position was intact as a critical supplier to Eskom's 40-year old installed base of heat exchangers and impellers. As one would expect, Eskom is pushing for price concessions, but we do not expect them to be punitive – although Howden needs Eskom, Eskom needs Howden as well. We averaged down on our position early in July, reducing our average cost to just under ZAR 40/share. For context, Howden should finish 2014 with about ZAR 12 in net cash on its balance sheet, and should generate FCF of ZAR 3/share or so this year.

We also met with the managers of PSG Group's three main holdings, in addition to the head of PSG's private equity group. We're more convinced than ever of the quality of Capitec and Curro's franchises, and we think Konsult has very promising future as a leading independent provider of financial advice, especially if SA regulators follow the UK's example of disrupting the economics of "tied" agents at banks and insurance companies. Unfortunately, the valuation of PSG seems to reflect these bright futures more than adequately, so we'll need to wait for better valuations before increasing our currently small position. As we write this letter in late July, Curro has announced a bid for the second-largest private school operator in SA, so perhaps that opportunity will come sooner than later.

Growth and Moats

More than once in the past few months, we've found ourselves chatting with fellow investors about the relationship between growth and competitive advantage, so we thought it might be worth spending a little time laying out how we think about these two topics.

For starters, let's stipulate that growth and competitive advantage can be – and often are – completely independent of one another. A company can grow like Topsy without any competitive advantage whatsoever, and companies with very wide moats can struggle to grow. Contrary to the opinions of many investors (and the assertions of many corporate managers), adding revenue or EBIT today says nothing about a company's ability to generate ROIC>CoC several years into the future. The long history of short-lived retail concepts, flash-in-the-pan products, and supposedly world-changing technologies that never changed anything should all be ample proof.

On the flip side, a company that dominates a mature market may enjoy a wonderful annuity-like stream of revenue and very low capital investment requirements – leading to high returns on capital – but without winning new clients or expanding the addressable market, growth will be an enormous challenge. For example, Dun and Bradstreet utterly dominates the North American market for commercial credit information, but the company's revenue over the past decade has not even kept pace with inflation. (By the way, we're not picking on D&B, since the company has allocated capital in a reasonably prudent fashion by retiring about half its shares since 2005.)

Things get more interesting when the Venn diagram of growth and competitive advantage intersect. Moaty companies that pursue growth for its own sake – "investing outside the moat," in our parlance – are essentially setting shareholders' capital on fire by shoveling it into sub-cost-of-capital endeavors. Needless to say, we don't spend much time looking at companies pursuing this type of strategy, unless they happen to be competing with ones that we own or follow. And as our recent sale of XPO demonstrated, we will part ways with managers who go off the reservation and begin to pursue growth for growth's sake.[6]

But when companies have the opportunity (and acumen) to deploy increasing amounts of capital inside their moat at high incremental returns…that's when we get really excited, because that's how Munger-style "lollapaloozas" are created. These types of businesses have some wonderful characteristics.

First, and most obviously, the rate of return on internal corporate projects for a moaty business is *much* higher than the rate of return on capital deployed in public equity markets. The number of *companies* that have sustained 20% returns on capital for long stretches of time vastly outstrips the number of public equity *managers* who have pulled off the same feat. So, we're very happy to let a moaty business hang on to our capital and invest it internally, because their internal opportunity set offers far better returns than what we could achieve investing the same capital in other public equities. Of course, if a company's business is such that it cannot absorb all the cash that it generates, we'd rather they return it to us than hoard it against a rainy day that will never come. (Are you listening, Silicon Valley?)

Second, companies that have the opportunity to reinvest inside their moat have easier capital allocation decisions. All that management has to do is more of what the company already does well. Executives don't have to waste time pursuing a "second leg" of growth, or looking for "transformative" acquisitions. They can focus on growing the business and widening the moat, which are much more likely to be value-creating activities. In short, they're less likely to do something dumb with shareholders' money because the smartest thing to do is what they're already doing.

[6] This is, of course, a subjective decision – XPO may turn Norbert Dentressangle into a value-creating home run. If it does, we'll eat some crow and learn from the mistake.

Finally – and here's where the relationship between moat and growth really kicks in – a company can only sustain high returns on incremental capital if its capital-deployment opportunities are constantly increasing. The relationship between the rate at which cash flow increases (G), the rate at which cash flow can be reinvested (IR), and the return on new invested capital (RONIC) is fixed: RONIC= G/IR.[7] If a company cranks up its reinvestment rate, RONIC *must decrease* unless growth keeps pace. For example, a mature company growing at 5% cannot reinvest more than 50% of its new capital without RONIC falling below 10%. By contrast, a company growing at 12% can reinvest at a 75% rate and still generate a 15% return on new capital.

Hopefully, this brief detour into the bowels of valuation theory helps clarify why so much of our research is focused on the *qualitative* analysis of competitive advantage and reinvestment opportunities. Without a thorough understanding of a company's moat and growth potential, the formula above is just empty math with no grounding in reality. But with that understanding, it becomes a tool that can help us identify when growth and moat catalyze each other to create substantial value for shareholders.

Thank you for your confidence and support. Please feel free to contact us at any time with questions.

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[7] From McKinsey's classic valuation text.

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