ALPHYN CAPITAL
MANAGEMENT

Alphyn Capital Management, LLC
100 Duffy Avenue, Suite 510
Hicksville, NY 11801
samer@alphyncap.com
www.alphyncap.com

Letter to investors, Q3 2020

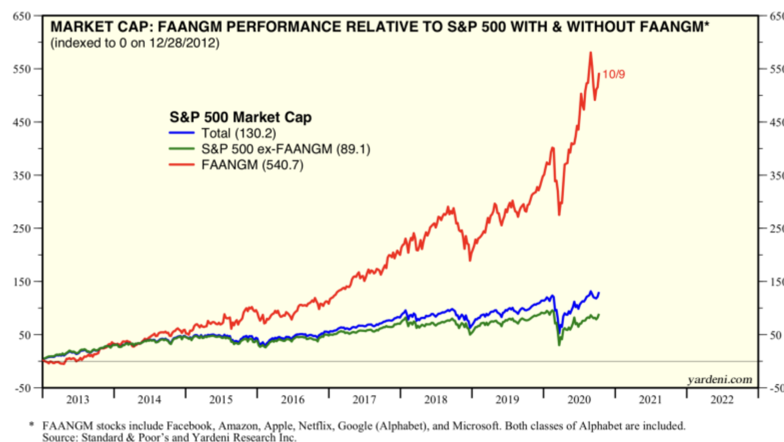
Performance

The Master Account, in which I am personally invested alongside SMA clients, returned -0.7% net in Q3 2020, as reported by our fund administrator. As of September 30th, 2020, the top ten positions comprised approximately 69% of the portfolio, and the portfolio held approximately 17% in cash.

	ACML	S&P500 TR
2019	18.9%	31.5%
2020 YTD	-11.0%	5.6%

Growth Companies

The remarkable performance of the S&P500, especially against the backdrop of COVID-19, government mandated shutdowns throughout much of the world, and stress in the "real economy" has been driven predominantly by the large technology stocks. For example, the chart below from Yardeni Research[1] shows the outsized impact of the FAANMG companies on the index's performance over the last half decade.



The FAANMGs are clearly dominant companies, built by visionary founders who have developed some of the most powerful competitive advantages anywhere in the world, driven by some of the best business models. These behemoths gush cash flow (except Netflix) and enjoy rapid growth without needing to deploy much capital. We did avail ourselves of the opportunity in March of this year to pick up some AMZN and GOOG stock.

Beyond the FAANMGs, the broad tech space has enjoyed impressive gains this year, especially Software as a Service (or SaaS) companies and those involved with cloud computing. For example, the WisdomTree Cloud Computing (WCLD) ETF has gained approximately 68% in 2020. These companies, overall, while not yet possessing moats as powerful as those of the FAANMGs, nevertheless are beneficiaries of the large structural shift online. This shift predates COVID, but has certainly accelerated with social distancing and work from home. As a

[1] https://www.yardeni.com/pub/faangms.pdf

result, these companies are experiencing much vaunted s-curves of adoption resulting in rapid and sustained sales growth, and the market has rewarded them with impressive valuations. The WCLD ETF constituents, for example, have an average price-to-sales ratio of over 12x vs approximately 2.4x for the S&P500. Price-to-earnings or Free Cash Flow are often meaningless as many of the companies are loss making. With the benefit of hindsight, investing in these companies would have been quite profitable. For example, respected investor Joel Greenblatt commented recently in a podcast "If you bought every company that lost money in '19 that had a market cap over $1bn, you'd be up 65% so far this year."[2]

The issue is that to justify current stock prices, let alone leave a margin of safety or room for upside in order to generate a healthy investment return for the risk taken, one has to extrapolate very high rates of growth far into the future, and to further assume profits and cash flows will eventually materialize due to operating leverage. While Amazon famously grew for many years with razor thin margins as it reinvested in its business knowing that it could "turn on the taps" of cash flows at any time, many of today's companies have not yet built the same dominant competitive advantages, yet are being valued on the assumption that their success is all but guaranteed. As another respected investor, Howard Marks of Oaktree Capital, frequently says, "the most important thing is how much optimism is reflected in the share price." While many of the cloud companies can, and some most likely will, "grow into" their valuations and beyond, we try to be careful about taking these types of bets.

With that background, in the next section I will summarize some decisions taken in the quarter with respect to our holdings in smaller tech companies. We exited OneSoft Solutions (the company has not demonstrated the ability to "cross the chasm" to rapid revenue growth), continue to hold WANdisco (there are good reasons to believe the opportunity for rapid revenue growth is high), and initiated a new investment in IAC/Interactive (its subsidiaries are growing rapidly with significant online transition opportunities, which is not reflected in the share price).

Discussion on a selection of portfolio positions with an average weight over 1%:

Positions with an average weight over 1% of the portfolio throughout the quarter were: Alphabet Inc., Amazon Inc., Brookfield Asset Management Inc., Burford Capital Ltd, CarMax Inc., Ceridian HCM Holding Inc. (via options), Colfax Corp, Crossroads Systems Inc., Exor NV, Fairfax Financial Holdings Ltd., GCI Liberty Inc., IAC/Interactivecorp, KKR & Co Inc., Naspers Ltd., OneSoft Solutions Inc., Prosus NV, Tencent Holding Ltd., and Wandisco Plc.[3]

Ceridian – options expiration

The short Ceridian options expired (profitably) and I am actively looking for an opportunity to buy shares in both the master account and client accounts. Clients who invested with us more recently own Ceridian shares directly, as the timing of their investment was such that option prices were less attractive and it made more sense to gain exposure to Ceridian via shares. I am looking to harmonize our portfolios by buying Ceridian shares in the master and remaining client accounts, but only if should the opportunity present itself (i.e. we have an attractive share price).

OneSoft Solutions - exit:

I often like to take starter positions in companies as I continue to track their developments that either prove out a thesis, which can result in me purchasing more, or disprove a thesis, allowing me to exit the starter position while minimizing damage to the portfolio. We exited a small position in OneSoft Solutions, a Canadian microcap company that produces software for the gas pipeline industry to "predict pipeline failures, save lives and protect the environment... with the assistance of data science and machine learning.[4]" Over time it became clearer to me that the company has not yet "crossed the chasm" into widespread market adoption. I was initially encouraged by the obvious use case, after all pipeline explosions kill 15 people and injure 62 people on average per year and have

[2] https://podcasts.apple.com/us/podcast/masters-in-business/id730188152?i=1000494215838

[3] There is no assurance that any of the securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable. See "Disclaimers" at the end for more details.

[4] Investor presentation for the Virtual MicroCap Leadership Summit on September 25th, 2020.

caused $9 billion of damage over the last 20 years. OneSoft further appears to have several tail winds, for example the pipeline industry body PHMSA is pushing legislation that prioritizes safety which should play to OneSoft's hand, and OneSoft claims a technological lead of 3-5 years over competitors.

Despite these and other factors, such as Microsoft selecting OneSoft as a 2020 Global Finalist for Partner of the Year, a partnership with Worely (a global provider of professional project and asset services in the energy sector), and an early contract with Philips 66 (widely seen as an innovator in the energy industry, as a test case for the company's technology and solution), they have so far failed to generate strong revenue growth, the acid test of customer adoption and acceptance. As the company's management disclosed efforts to "evolve and expand" the sales force, and to reassess their commercialization strategies given various frictions with getting customers to deploy their solutions and upload large amounts of necessary raw data, it became increasingly clear they were struggling to define their go-to-market strategy, hence the exit. OneSoft might still prove me wrong, accelerate sales and become a runaway success, but it is a risk I am not prepared to underwrite at this stage. Should the circumstances change, I may revisit the company in the future.

WANdisco – Update:
On September 17, WANdisco announced H1 results which comped 40% lower than H1 2019 and disclosed it would not meet 2020 full year guidance. This combined with the poor optics of insider sales that occurred in June and July (regardless of any justification given at the time that management's share sales were to fund personal expenditure/lifestyle requirements) has understandably meant the company has lost some credibility with the market.

It is not lost on me that some might view WANdisco with a similar lens to OneSoft mentioned above; after all it is a small software company that is attempting to sell its services to much larger enterprises, through a partnership with Microsoft (and Amazon Web Services in the near future), and has so far delivered much in the way of promises and little in the way of cold hard revenues.

However, there are some important distinctions and I believe the thesis has not been materially impaired. Most important is that in June WANdisco LiveData Platform for Azure went into Limited Public Preview. This first party native Azure integration is fundamental to the thesis, and it is encouraging that WANdisco has received public endorsement from the Corporate VP at Microsoft responsible for Azure Storage. By September WANdisco had signed up 46 customers through this integration who are starting to use the service, well ahead of the goal of "50 customers in 12 months" announced in June. WANdisco expects Microsoft to launch Open Public Preview some time in October.[5] The distinction between private and public is important in two ways. First, it is reasonable to expect the rate of customer adoption to increase as the service moves to public, second, billing and therefore revenue to WANdisco does not start until Microsoft launches Open Public Preview. In the meantime, there has been a further impact to WANdisco H1 revenues as enterprise customers have delayed buying WANdisco licenses, preferring to wait until Azure is fully live. While unfortunate from an interim results perspective, intuitively it makes sense for large enterprises to deal directly with Microsoft with an integrated bill for cloud services on a metered basis, rather than sign with a small company under an old licensing model.

Nevertheless, WANdisco has announced a handful of key customer wins that demonstrate the effectiveness of its technology at scale. Here is an abridged timeline:

- June 1st - WANdisco LiveData Platform for Azure available in Limited Public Preview. Claims 200-300 exabytes TAM and expect to sign over 50 new customers on the Azure platform within 12 months.
- June 2nd - reseller agreement with Infosys, successful completion of a large (3 petabyte) migration for Starbucks from Azure ADLS generation 1 to 2. This is important as a real test of the Azure integration and product working at scale under live conditions.
- 5th June - contract with American Airlines "WANdisco's technology was the default and sole technology capable of moving the live data set to the cloud within Azure's ecosystem without disruption."

[5] Public Preview <u>with</u> metered billing did indeed launch at the time of this writing, but after quarter end

- July 1 - $1m contract with a major British supermarket. 11 other customers signed up in the first month of Limited Preview.
- July 16 - contract with large insurer. Announces 28 customers signed up.
- August 5th - announces "Competency Status" with Amazon's AWS (see below).
- September 2 - announces Xandr, the advertising and analytics division of AT&T, is a customer.
- September 17 - announces H1 results, still in Limited Public Preview, has had 46 customer sign ups.
- September 17 - GoDaddy will migrate 500 TB of HDFS data to Amazon Simple Storage Service.

AWS Competency Status further validates WANdisco's product and reduces WANdisco's reliance on Azure. From the AWS website: "The AWS Competency Program is designed to identify, validate, and promote AWS Partner Network (APN) Advanced and Premier Tier Partners with *demonstrated AWS technical expertise* ... APN Partners are *vetted, validated, and verified* against a high bar to achieve the AWS Competency designation." The GoDaddy deal is interesting in two ways. First, it is expected to be a very heavy user in terms of data being replicated/migrated per second that we are told no other technology can handle. Second, it was sourced by AWS itself and not WANdisco's sales efforts, supporting the notion that WANdisco has a valuable product that other companies will seek out and deploy.

As a result of all this, WANdisco has updated guidance. "For FY21, we expect to migrate in excess of 100PB of data to the Azure cloud (with more than 50 customers signed over the year) and greater than 30PB into the AWS cloud. Combined with the flow of metered billing from Q4 this year we expect a minimum revenue of $35m in FY21." In the interim, the company has committed to disclosing KPI's (key performance metrics) to update investors on its progress.

IAC Interactive – New Position:
Please reach out to me via email should you be interested in the full 25-page writeup.

IAC is a holding company run by Chairman Barry Diller and CEO Joey Levin, proven business builders with an enviable track record of creating significant value for shareholders. Starting in 1995 with a collection of television stations called Silver King Communications worth $250 million, Diller has built IAC by investing in undervalued media and tech companies, developing them and spinning them out. Levin is Diller's chosen successor at IAC. He was formerly a mergers and acquisitions banker at Credit Suisse First Boston, and has been at IAC since 2003, where he has run several of its subsidiaries and chaired the boards of some of its companies, including Match Group, ANGI HomeServices, and MGM Resorts.[6] To date, IAC has spun out 10 separate publicly-traded businesses, including Match, Expedia, TripAdvisor, Tree, and LiveNation, collectively worth approx. $60bn.[7]

On July 1, 2020 IAC completed the separation of Match Group (~$30bn market capitalization) to shareholders. IAC emerged with a $3.9bn net cash position and a collection of high-potential internet focused businesses. On August 10, IAC disclosed it had deployed $1bn to accumulate a 12% stake in publicly listed MGM Resorts at an average price of $17 per share.

As of this writing, IAC owns an attractive collection of fast growing internet businesses operating in very large markets with strong offline-to-online transition tailwinds:

- An 85.1% stake in ANGI HomeServices (ANGI.NASDAQ) – a marketplace for home services and repairs operating in a $500bn market. 49% of consolidated revenues.
- Vimeo – IAC's hidden jewel, a fast growing SaaS company (sales up 47% in Q2) that helps businesses create and distribute video. 7% of consolidated revenues.
- DotDash – a portfolio of websites publishing need-to-know content in seven verticals, generating >20% EBITDA margins. 6% of consolidated revenues.
- Search business – a cash cow business. 27% of consolidated revenues.

[6] https://www.iac.com/about/leadership/iac-senior-management/joey-levin
[7] https://www.iac.com/media-room/press-releases/iac-and-match-group-complete-full-separation

- A collection of emerging businesses including Care.com, BlueCrew, and Turo; play to IAC's strengths at developing large online marketplaces. 10% of consolidated revenues.
- A 12% stake in MGM Resorts (MGM.NYSE), a casino operator with marquee name properties in Las Vegas and Macau, as well as exposure to the explosive growth in online sports betting and iGaming precipitated by changes to US gaming legislation.

IAC is a good example of a company with "synthetic leverage," a term I define broadly as companies with advantaged business models that can safely leverage alternative third-party sources of capital or operations to generate significant incremental income. First, at a time when fast growing SaaS-type businesses routinely trade at double digit Price-to-Sales multiples, investors can buy IAC with a significant margin of safety, as the company trades at an approximate 14% discount to a conservative sum of its holdings, and an 94% discount to a bull case. Second, IAC uses spin outs not only to realize tremendous value for shareholders (by closing discounts and allowing those share prices to compound) but also to raise cash to invest in its next group of companies, as it did with the $3.9 billion it received from the Match separation.[8] Third, despite Diller's protestations that IAC is the "anti-conglomerate," he leverages skill synergies across the group, for example using Vimeo's video expertise to benefit other IAC companies, and using IAC's online expertise to help MGM grow online.

IAC presents investors with an attractive set up. On the one hand, risk of permanent impairment to capital is low: 25% of the company's value is in cash (overseen by great capital allocators), and it is undervalued especially when compared with fast growing internet stocks. On the other hand, IAC has a lot of optionality and multiple "shots on goal" with $2.7 billion to deploy and the potential for any one of ANGI, Vimeo, MGM, or its emerging businesses to add a significant valuation uplift should they make inroads into their very large respective markets. At the time of our investment, IAC was available at a discount to the sum of its components even when valued using undemanding assumptions, which does not reflect its long history of compounding value for shareholders.

Closing thoughts

While I have focused in this letter on some of the higher skew names with the potential (though no guarantee of course) to generate significant returns for the portfolio, overall we still follow the barbell type strategy outlined in previous letters. Approximately 70% remains invested in large and well established companies I consider to have strong moats, robust cash flow generation, proven management teams and, of course, synthetic leverage. These have the potential to compound well for us over time, regardless of short term market fluctuations.

Samer Hakoura
Alphyn Capital Management, LLC
October 2020

[8] IAC received $838 million ($3/share of Match as cash funded by Match taking on new debt) + $1.4bn from the sale New Match shares + $1.7bn from shifting exchangeable debt onto Match's books in exchange for an equivalent reduction in its stake in Match. Total ~$3.9bn.

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