Vineyard Holdings

September 2021

PERFORMANCE AND PORTFOLIO UPDATE

Year	Vineyard Holdings (%)	S&P 500
Sep - Dec 2019	3.6	10.39
2020	101.6	16.26
2021 (YTD)	19.59	22.13
Annualised	35.8	16.2
Since Inception	150.2	56.7

Dear friends,

The fund returned 1.14% since our last letter in Q1 of this year. This puts the year-to-date return at 19.59%. Nevertheless, smooth runs the water where the brook is deep - the flat return belies the tumultuous last few months.

The period April through September has seen heavy Chinese tech regulation and 50% swings for crypto from peak to trough, and back to peak again. Some South African holdings have knocked the ball out the part, benefitting too from a strengthening Rand. Globally, some holdings have cooled off from their runs from Q1 of this year.

The biggest detractors have been our investments in China through Prosus and Alibaba, returning -2.01% and -1.82% respectively for the fund. Our biggest performer was Ethereum, adding 3.74% overall. I comment on several portfolio holdings below, and share research on the portfolio on the fund's website (www.vineyardholdings.net). Given our long-term time horizon and preference for long-duration comounders, the portfolio turnover is sitting around 10%.

For those new to the fund, it is a long-only, concentrated multi-asset portfolio composed mostly of equity in global, high-quality companies creating shared value.

THE EVOLUTION OF A GROWTH INVESTOR

Several years back, Guy Spier wrote a book called *The Education of a Value Investor.* It was a book I recommended in my first ever investor letter. I enjoyed it, and full praise to Guy - it's a good book. The foundations of price discovery, distancing oneself from the market's noise, and paying less than the sum of future cash flows are pivotal to the kind of investment we do. These principles have been burned into the collective consciousness of investors through the success of the Berkshire duo, the frequent homage paid to Benjamin Graham, and the simple "price is what you pay, value is what you get" type aphorisms investors like to put in their letters.

These are right and good, and I want to stress their importance as core principles. However, where they were once radical - investing was akin to augury back in Ben Graham's day - they are now a sight more orthodox. Without commenting on Guy's book, there has been an irksome lack of progress in mainstream value literature over the last decade: the fact that some folk will still lean on book value to value a software company is simply silly.[1] But irreverence is not an endearing trait, especially in the young. So, let me frame this letter instead as some lessons learned in *The Evolution of a Growth Investor*.

Our understanding of Smithsonian economics grew up during the Industrial era of "brick and mortar" businesses. In this time, there was an asymptote to scalability: at some point, buying a new textile machine makes no sense because you're the only person selling textiles in your town and there is nobody else to sell to. Increased investment doesn't mean increased sales. These companies may earn outstanding profits for a while, but inevitably have a return on capital that will revert to their industry average over time. The bulk of our financial methods today were developed around these companies. The way we account for a company's performance, the valuation methods we use, many of the ways we see competitive advantages - these were not developed in the "bits and bytes" world we live in today.

Software carries zero marginal cost and scales non-linearly. This is not a mould that fits regression-to-the-mean well. For example, unlike old-economy businesses, many software companies can continue to sell repeatedly to the same customers at increasing price points. They can do this, because they can improve their product offerings and aggregate the cost over their already-large customer base. Unlike the old textile mills, they don't need to buy a new machine with every thousand customers. They have better unit economics, stickier customers, and less competition with scale. This way they continue entrenching moats and earning

[1] For those interested, Mauboussin has a good read on the rise of intangibles in valuation here.

above-market returns for far longer than we originally thought.[2] Netflix or AWS are good examples of this.

Crudely, we can group the world up into two buckets: mean-reverting (industrial era) businesses, and increasing-return (internet era) businesses. Understanding either bucket takes time, and time carries an opportunity cost. To underwrite an industrial era miner, you need to understand the commodity. To underwrite an apparel business turnaround, you'd need to have built mental models around the steps an incoming CEO should take and what end consumers will like. These all take time to familiarize yourself with. This is time spent not understanding the network effects or product strategy of a global delivery platform, or an edutech provider. Ben Graham's margin of safety still applies! But as always, it's about future cash flow. Neither low multiples, nor eye-popping growth rates are by themselves a margin of safety - investors actually have to do the legwork on the business.

If running a concentrated portfolio, it's a good heuristic to make sure you are in the top 1% of people who know about a business before you invest in it. Since so much time will thus be spent trying to deeply understand a handful of business models, being guided by interest level is certainly healthy. You are not going to be in that top 1% if you are not obsessively interested.

Reinvestment, long-duration growth, quality… I enjoy studying these traits tremendously. Over time, and with increased AUM, it seems many investors have taken this approach after starting with deep Grahamian value. There are not too many instances of folk going from quality to value.

Things we look for at Vineyard Holdings

It helps that quality has outperformed over the last few years. Shifting market dynamics have both caused and reflexively been caused by many changes over the last decade:

- The Internet has spread knowledge at a rapid pace. There is now little "information edge" left for investors who fish in the more popular markets.

[2] W Arthur, *Increasing Returns and the New World of Business,* 1996.

- Retail education and participation (via low or no-cost brokerages) means more money flows into particular stocks.[3]
- A decade long bond rally and loose monetary policy.[4]
- A rise in passive index investing which mandates buying of large caps.
- The monopolisation and consolidation of market makers in derivative markets means there's increased volatility and drives the momentum factor.

These factors have all served to propel the large, quality names forward over the last several years. COVID has similarly highlighted the importance of software companies with the work-from-home drive. Some of these changes are structural, and will continue to spur the same names. Others are perhaps drawing to an end - and those who have benefited from them should be wary. Navigating these changes is part of an investor's evolution.

WHAT WE ARE LOOKING FOR

So with this evolution in mind, what should investors look for today? Inflation could rear its head, rates may rise, pandemics may strike… Very few individuals can reliably predict with accuracy. It's almost rote to say the market is a *complex, adaptive system*. The ensemble of the market works totally differently to the individual pieces within it. Correctly guessing the big is hard - correctly guessing how the big will affect the little is almost impossible. Fidelity's renowned Magellan Fund manager Peter Lynch put it well: "*if you spend thirteen minutes a year on macroeconomics, you've spent ten minutes too many*".

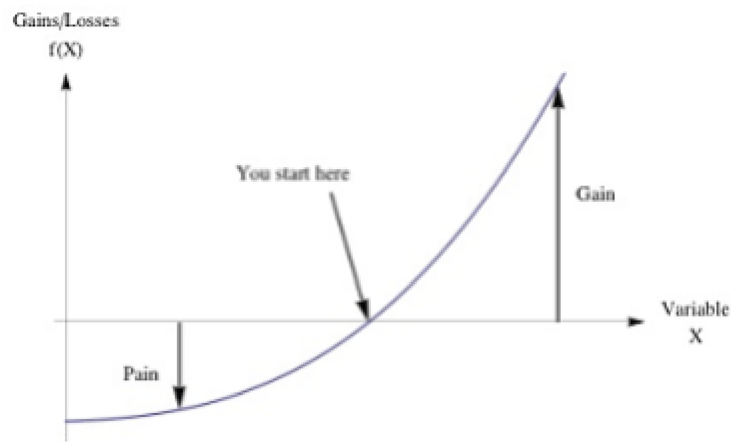
That said, there are certain broad predictions I feel comfortable making. A few examples: customers will always want better things at lower prices. The world will get progressively more digitised. Quality and leisure goods will grow as a portion of expenditure as the world's standard of living improves. There is a global shift in power from West to East. These are a couple of the long-term thoughts in my head around which long-term predictions can be oriented.

Yet, in a complex environment, businesses need more than thematic tailwinds. They need to be deeply *resilient*, and they should look to grow *optionality* within their business. Resilient businesses make a habit of trading pain today for gain tomorrow - Amazon's funnelling of retail profits into cloud infrastructure is the seminal example. They are both highly adaptable and

[3] Newfound Research, *Liquidity Cascades,* 2020 and Barclays, *Impact of Retail Options Trading,* 2020
[4] Lyall Taylor, *Liquidity Flywheels,* 2020

experimental, yet the core of their business is the first broad prediction above: customers will always want more for less.

Mohnish Pabrai's mantra of *"heads I win, tails I don't lose much"* is the beginning of optionality. It is a convex payoff that comes from a small investment - here we can think of Google's Other Bets segment, Facebook's Reality Labs, or the business model of venture capitalists. These are all examples of optionality.



Taleb famously calls convexity *antifragility*. The trait of benefiting from extreme events.

But optionality is also cultivable. At a business level, companies can continuously make the choice to invest in projects which give them more options later on. These projects don't necessarily need to pay off themselves, they just need to open doors that could pay off later. An example of this was Tencent's decision to disrupt their flagship social media product, QQ, with WeChat. By pitting the two against each other internally, Tencent's management ended up developing what has been called *"the operating system of China",* a product that has opened them up to advances in payments, gaming, media, and now enterprise connectivity.[5]

Typically, these companies don't screen well. Usually they look expensive - they could be under-monetized, going through their J-curve, and/or investing in a way that hides profit. Valuing these companies is a blend of art and science. One one hand, investors need *inter alia* a deep understanding of the unit economics, what a steady-state would look like, and some reasonable guesses as to what the total market size is. These are a little more quantitative. We can overlay these with base-rates and metricised milestones. Looking at capital structure, the resilience of the product, and the competitive advantages of the company can help narrow some of the guesswork here. On the other hand, the qualitative aspect is more subjective. These companies require visionary management, innovative teams, and an appreciation of the broad, thematic tailwinds that carry them forward.

[5] Connie Chan, a16z.

Estimating future cash flows is a lot easier when a company has an entrenched competitive advantage. Unfortunately these advantages are often the result of rare or unpredictable events, like IBM's asking Microsoft to make them a PC operating system despite Microsoft never having built one before. Very few startups get to experience these types of events. Because of this, the uncertainty around investing in young businesses - no matter how disruptive they may seem - may be too much to feel confident about gauging the outcome range. As valuation requires roughly bounding an outcome range for a company, I prefer to focus the bulk of the portfolio on companies which already have such advantages.

PORTFOLIO COMMENTARY

By way of portfolio commentary, there is always the dual edged sword of incentives: we are paid for acting on good decisions, not for writing cautionaries in investor letters and later saying *"see, we told you so."* This is why very few investors say bad things about their holdings in public. In reality, there are always question marks. Uncertainty is part of the game and radical candor is something I'd like to encourage in the fund's DNA.

I have outlined below the *explain-like-I'm-five* theses for several of our core positions, and one or two risks to keep an eye on - please feel free to reach out to me if you would like to discuss any position further.

PROSUS[6]

Prosus' fate is tied to that of Tencent - the $570bn tech giant in China. They own roughly 28% of the company, and trade at $172bn themselves. Tencent has been hammered 40% off it's recent highs by Chinese antitrust and data privacy regulation over the last year.

While Chinese equities may justify carrying a higher risk premium, their tech giants are not facing existential crises. Nor are they earning materially less than they used to. They have considerable growth ahead in cloud infrastructure and enterprise software. Tencent funds this growth through their nation-wide ecosystem of gaming, ecommerce, media, cloud, and artificial intelligence products and subsidiaries. They are one of the largest entertainment companies in the world and use their strong cash and data generation from their core operations to fund and inform their venture capital arm.

[6] I have written extensively on Tencent here.

They own the widest reaching social media platform in the world in WeChat, which – along with their gaming distribution – provides them with prospective advertising dominance in the future. They have an outstanding Berkshire-esque portfolio of investee companies, and have transitioned excellently from a China-only, state-protected imitator to a globally scaled patient innovator.

Prosus - as a Tencent proxy - trades at roughly a 45% discount to NAV and has a bunch of high-growth payments, food delivery and edutech companies in its portfolio alongside Tencent. Their strategies in each of these realms is to build globally competitive networks complete with end-to-end offerings. Currently - if Tencent is fairly valued, and if these other bets are merely options - investors are getting a global tech giant and a portfolio of optionality, all growing topline well above 30% year-on-year, for around 25 times earnings.

KAROOOOO[7]

Previously Cartrack, Karooooo is a global SaaS company, which installs little telematics devices into cars (both at OEM and retail stages). They use the data from the devices to provide customers (who are mostly fleet managers) with insights to their vehicles. These include task management, automated dashboarding, improved safety, maintenance planning, route logistics, etc. These often result in cost savings for customers, and improve the way logistics managers can interact with their own clients.

Telematics is a big market globally, with only a handful of players of Karooooo's size. They have low subscriber churn, an LTV/CAC of around 5, and have consistently grown recurrent sales and subscribers above 20% per annum. Regulators are encouraging more fleet managers to use telematics, and insurance companies are subsidizing retail users to install these devices in their cars so they can better tailor car insurance premiums. The company is currently trading at around 13 times EBITDA.

Management has been pretty good at adapting in the past - their acquisition of Picup (a last-mile delivery service) and development of Carzuka (an online vehicle trading platform which finances and insures vehicles with a full telematic history) are two recent examples of baking optionality into the business.

Two concerns about Karooooo: Firstly, there have been numerous complaints about the company culture at the R&D headquarters in Singapore. In part, this may be because of the dominance from founder-CEO Zak Calisto. It may also be from the stark differences between

[7] I have written extensively on Cartrack here.

the South African and Singaporean business cultures. Secondly, their growth in South-East Asia has been less than originally expected. They have been hampered by the varying lockdowns per country, and have not yet realized the land grab that their increasing marketing efforts suggest they will. As theirs is a winner-take-most industry, this lack of rapid scaling may give way to a more aggressive competitor.

TRANSACTION CAPITAL

Transaction Capital (TC) is a South African investment vehicle. Their three main businesses are SA Taxi, WeBuyCars (WBC), and Transaction Capital Risk Services (TCRS). The management team is one of the most highly regarded in the country, and have thus far compounded shareholder capital at 32% per annum since 2014.

Roughly 70% of South Africa's population uses minibus taxis daily for transport. SA Taxi is the leading taxi financing business in South Africa - they provide insurance, group buying services, maintenance and data collection services for taxis. By mandating that the taxis they finance use Cartrack's telematics devices, they are able to better price the commoditized loans, undercutting banks and alternate lenders. By vertically integrating, they have created a one-stop-shop ecosystem of auto repair, insurance and route optimisation services for taxi owners where they give discounts and rewards as owners make more use of their various services.

WeBuyCars is the South African equivalent of Carvana. They are an entrepreneurial, owner-managed bunch who are disrupting the used-car sales industry. They offer a platform for folk to buy and sell cars on, infrastructure to collect, store and refurbish the cars, and are branching (with the help of TC's management team) into vehicle finance and insurance. South Africa's used-car market is large (~10m cars on the roads) and fragmented, with most players being smaller Mum & Pop outlets.

WeBuyCars Comparison	WeBuyCars	Carvana	Vroom	Carmax
	JSE:TCP	*CVNA*	*VRM*	*KMX*
Growth				
Revenue ($'m)	446	5 587	1 357	20 319
3Y CAGR (Revenue)	62%	87%	39%	9%
Annual Vehicles Sold ('000)	65 510	244 111	62 981	832 640
3Y CAGR Vehicle Growth Rate	58.1%	76.7%	20.7%	7.4%
Valuation				
EV/Revenue	0.49	8.30	3.17	1.97
Enterprise Value ($'m)	218	43 209	4 783	30 030
Business Efficiency				
Advertising as a % of Revenue	1.5%	4.2%	5.2%	0.9%
Avrg Inventory Days to Sale	24.3	62	68	52
ROE %	62%	-70%	-62%	25%
Operating Margin %	8.2%	-5.9%	-13.2%	3.9%

WeBuyCars outperforms most international peers

WBC has vertically integrated and offers both buyers and sellers a much higher value proposition: a turnkey, get-the-best-deal platform. They have strong unit economics, compare favourably with international peers, are growing rapidly, and have a sizable lead over all African peers. The network effects of a marketplace, and the infrastructure costs to set up warehouses and the collection services across the country make it tougher for competitors to challenge them as they grow. Keith Rabois said it best: *"the formula for startup success is to find a large, highly fragmented industry with low NPS and to vertically integrate a solution by simplifying the value proposition."*

TRCS is the group's debt collection service. It is a bunch of companies doing non-performing loan collections, transactions and business outsourcing services. Of the three subsidiaries, TCRS is likely the weakest: South Africa's Consumer Credit Rehabilitation Index, which measures how likely consumers are to repay their debt, isn't great at the best of times, and COVID doesn't help. On one hand, this helps as they can acquire loans from others on the cheap, but then they're still stuck with the worsening default rate and country-wide unemployment.

At 25x earnings, Transaction Capital is more pricey than it's been in a long while. However, the data moat of SA Taxi, the disruption from WeBuyCars, and the managerial excellence from the head office team justifies the improving investor sentiment - this is an excellent company at fair value.

ETHEREUM[8]

As the fund is not limited to equities alone, Ethereum has been a holding for several years now, and it has grown into a core holding of the fund. As a 10 second primer, Ethereum is the crypto protocol that underpins the decentralised finance (DeFi) movement, where users transact peer-2-peer without 3rd parties like banks. It also underpins the non-fungible token (NFT) movement, which creates digital scarcity for objects like art and certificates, and the decentralised, autonomous organisation (DAO) movement, which enables groups to join up in new ways to achieve certain preset goals.

Ethereum is somewhat like a high quality "company" with a win-win ecosystem which is trading at a pessimistic valuation.

It has strong network effects, forms the basis for web3 (the decentralised internet) and – thanks to the changes to the protocol in August and the upcoming early 2022 proof-of-stake rollout– it also presents a "special situation" with expected upside volatility. Some of the below will be a

[8] I have written extensively on Ethereum here.

little technical. If the jargon gets a bit much, I recommend reading the essay I wrote on Ethereum.

Every four years, Bitcoin goes through a “halving cycle” where the amount of Bitcoin produced is cut in half. The subsequent supply/demand mismatch has historically been reflected in the price going parabolic with each halving cycle. Ethereum, which is changing the way ether tokens (the “currency” of Ethereum) are produced and used, will go through a similar process over the coming year. This is the short term thesis and provides the margin of safety for the long term thesis.

The long term thesis is that Ethereum is the best way to index the decentralisation of the web, of finance, and of created content. Crypto protocols like Ethereum allow for users and creators to reap the benefits of their capital, work, and creativity more efficiently than banks and centralized web-based companies.

The big question marks around Ethereum are: can it scale, and will it be better than alternatives? Regarding the scaling, state management is always a challenge with decentralized systems. Any time you have to update thousands of computers around the world simultaneously, you will encounter a higher energy cost per update (and it will almost inevitably be slower than centralised systems). While clever features like rollups and sharding will improve throughput and lower transaction costs (to well below the Visa/PayPal payment processor equivalent), they will struggle to compete on computation cost/byte with infrastructure/cloud providers.

As far as being better than alternatives goes… it beats almost everyone in at least one thing, often more, but is also usually beaten in one or two features. Is it cheaper and faster than banks and payment processors?[9] Yes, but the onboarding experience is super clunky. Does it improve on existing financial ecosystems? Yes - it has a lower cost base, better security, more aligned incentives, and the interoperability provides a better platform for innovation. Is it better than other blockchains? This is debatable. It has the best and largest developer ecosystem and will be one of the fastest and most scalable, but Solana, Cardano, and even Bitcoin all have their own claims to being the best foundational blockchain.[10]

[9] Because we are looking long-term now, I am writing under the assumption that Eth2.0 is effectively rolled out come 2022.
[10] There has been progress recently in multi-chain technology - which is the linking of various blockchains together for interoperability, but these face their own constraints (such as liquidity fragmentation and, again, state management issues).

Vineyard Holdings is currently closed to new investors.

If you have made it to the end of this letter, I applaud you. This section is reserved for commentary on life and investing in general, please feel no compulsion to read on. Those who entrust their money to me should understand the patterns I think in, and the foundations on which those patterns are built. This half-page is to help unpack that.

The below excerpt is from an essay by David Perell titled *Peter Thiel's Religion.*

> *"In a thought-provoking essay called* Peter Thiel and the Cathedral, *Pascal-Emmanuel Gobry argues that Cathedrals were the equivalent of the Apollo project in the High Middle Ages. Like America's Apollo program, each Cathedral required a specific and ambitious plan for building it. Medieval cathedrals were the first man-made structures to soar higher than the Egyptian Pyramids, which were monuments to death. But cathedrals are dedicated to the triumph over death. Moreover, cathedrals can only be built with scientific knowledge and communal support. They require scientists, mathematicians, engineers, craftsmen, and artists. And all of them need a long time horizon.*
>
> *… Long time horizons aren't just psychological. They're cultural. Modern society suffers from temporal exhaustion. Or as sociologist Elise Boulding once said:* "If one is mentally out of breath all the time from dealing with the present, there is no energy left for imagining the future."

The point made by Perell throughout the essay is that Peter Thiel's worldview - Christiantiy assembled atop an understanding of Girardian mimesis - is what drives him to build as he does. The Christian habit of putting eternity above the present instills a long time horizon. In comparison, secular philosophy and Eastern religions practice more deeply experiencing the moment. You have one life. Or you lose your individuality and return to the whole. This is a good and right practice. But when we rush from meeting to meeting and strain our eyes at every well-written headline, it may be time to reassess our long-termism. Whether it is to build cathedrals, start-ups, or venture capital firms, we'd all do better to think in decades, not powerpoint presentations.

Below are the facts and stats about the fund as of September 2021.

This section is disclosed to our partners only.