JDP
CAPITAL MANAGEMENT

2022 Half Year Letter

Dear Partner,

In the first six months of 2022 the fund was down 44% on a gross basis compared to the S&P 500 which was down 20.5%. Please see your statement for net returns as performance will vary based the timing of capital contributions and share class.

I want to begin by welcoming the new families who joined The Partnership this year. The current environment makes for an attractive entry point especially for investors with a reasonable time horizon.

For those already fully invested (such as my family), we think the portfolio has more upside than at any time in its history.

Every position in our portfolio is selling for between 1x and 5x our estimate of operating earnings within the next few years. Several of our holdings now sell for 2018 prices despite the underlying businesses having grown to become multiples larger and stronger.

With the exception of Indivior Plc, the prices of our portfolio companies now reflect a sharp and destructive business deterioration lurking around the corner — a scenario we do not believe is reasonable.

The question is of course, how much of any dramatic price change (up or down) is driven by fundamentals versus anxiety about a daisy chain of outcomes that have not happened?

There is little doubt that a technical recession will happen at some point. What we monitor closely are the unanticipated company-specific outcomes that a downturn could have on what we own, both in terms of fundamental risk, and fundamental opportunity.

Great investment track records are built by welcoming fear-blinded markets and doubling down when uncertainty generates unexpected opportunity. The same mindset applies to great businesses that have delivered extraordinary value over decades.

Several of our holdings are aggressively taking advantage of their financial and market position to take market share from weaker and less focused competitors. We expect to see our holdings get stronger and expand when others are forced to fold.

Our portfolio is concentrated in sector pioneer-leaders growing within internally generated cash flow, have cash-rich balance sheets and are led by strong teams with a history of perseverance and grit.

As a reminder, The Fund's strategy is to make investments in businesses with substantial unrecognized earning potential, purchased on value basis. We want situations where we can earn multiples our money over a time horizon that is more common with a family office than a typical hedge fund. We gravitate towards businesses going through a major transition that might be controversial but where improving margin structure, competitive advantage, and customer adoption can be measured and confirmed.

Talking about strategy

In April I was interviewed by Millennial Podcast about our strategy and how we develop conviction in making long-term investments.

(click to listen)

ENDURANCE AND LONGEVITY

Having a framework for continuous ownership of a stock as long as the thesis is intact (or improving) puts the owner in a fortuitous position to maximize long term performance. It is easy to forget this when prices are falling and the urge to trade is so strong.

In his weekly blog, Morgan Housel accurately pointed out that endurance and longevity are the common denominator of almost all big fortunes.

"Compounding is just returns to the power of time. Time is the exponent that does the heavy lifting, and the common denominator of almost all big fortunes isn't returns; it's endurance and longevity"

We couldn't agree more, and would add, that great companies (on their own) do not make great investment. Secondly, it is more difficult to earn outsized returns holding on to a well-understood, market-loved businesses where the real fortune was made a generation ago.

If you haven't had a chance to read Morgan's book *The Psychology of Money* I highly recommend it as it is full of timeless investment wisdom.

TOP 5 POSITIONS

Spotify (-58% in H1)

In our view the discount in Spotify's valuation feels analogous to a sprawling Midtown Manhattan apartment complex valued on the replacement cost of the concrete and wood alone, while ignoring the land and future rental income.

Spotify's stock price is not only lower than its IPO price in 2018 but gives *negative* credit to the company's growth and transformation up the quality ladder since.

Our investment thesis is centered on the toll bridge-like earning power that Spotify is starting to extract from audio asset owners (music, podcasts, books) for search and discovery tools to drive engagement and monetization. Digital products and advertising are the drivers of future margin expansion, but contribution as a percentage of the company's overall revenue today is still small. Digital products also do not appear as a revenue on the income statement, but instead are booked similar to rebate against premium subscription revenue.

As an example, Marketplace's contribution to gross profit has compounded at 60% per year since 2018 and expected to be €210 million in 2022.

Podcast ad revenue is expected to be over €300 million in 2022, up from €200 million in 2021. What matters to us is that early every quarter the company demonstrates meaningful operational progress towards their target margin goals.

The internet removed the music label's status as gatekeeper to the consumer years ago. Music and audio content is largely commoditized, and the large content owners now sit in the background waiting to collect paid subscription revenue from partnerships with a handful of consumer tech platforms. Spotify's transition from a music streaming service to a data science provider that builds audiences around personalized listening and lifestyle, is opening up the next phase of audio monetization for the sector.

Beyond Paid Subscriptions

At the Spotify's Investor Day in June the company pointed out that the app is driving 22 *billion* discoveries per month, and that 1/3 of all new artist discoveries happen on a personalized algorithmic playlist. Within the past two years, 150,000 artists have been added to a Spotify playlist for the first time.

The bigger picture of applying what Spotify has built on top of music to include podcasts, books, and other audio has the potential to close the monetization gap between video and audio on the internet. This gap is one of the great wide-open oceans of opportunity on the internet and we think Spotify's advantage over video-first consumer platforms is unrecognized on Wall Street.

Ben Thompson: *"Notice how this business — in its mechanics, if not its financial numbers — looks more like a Google or a Facebook than a Netflix: Spotify isn't earning money by making margin on its content spend; rather, it is seeking to enable more content than ever, confident that it controls the best means to surface the content users want. Those means can then be sold to the highest bidder, with all of the margin going to Spotify"*

So how do we think about Spotify's intrinsic value?

At the recent investor day Daniel Ek shared management's 10-year target of achieving €20 billion in operating profit on €100 billion in revenue. Obviously getting even close to that would mean a knock-out for the stock based on today's $18 billion enterprise value.

As I mentioned in my note about the investor day, it is rare for a CEO to talk about financial goals that far out into the future and we would never try and model projections of any business out that far. But it's hard not to admire Daniel Ek for having the courage to share and declare goals like that with the in public.

We think Spotify can achieve 10% EBIT margins and €30 billion in revenue within the next few years. At that point the stock should re-rate based on proven margin expansion and growth outlook to a multiple that looks more like a large tech company or between, maybe 15 to 25 times EBIT. The stock is cheap even if Ek's long term goals are too ambitious.

Click to see JDP's Review and Highlights of Spotify Investor Day 2022

Indivior Plc (+20% in H1)

Indivior (LON: INDV.L) performance has been a bright spot in our portfolio, up 20% in the first half of 2022. INDV.L has appreciated by about 500% since we initiated the position in mid 2019 at a highly distressed valuation of less than the net balance sheet cash.

Indivior trades for a discount to our estimate of Subclade's run-off value without including the other smaller niche drugs, development pipeline, and value potential of the time-released injectable technology (platform) beyond opioid addiction.

In 1Q the company announced a second $100 million buyback as a way of intelligently reducing the excessive amount of cash on the balance sheet. Management also announced plans to list their stock in the United States later this year in order to widen the potential shareholder base and help close the existing valuation gap with peers.

In April we sold 1/3 of our stake at 300p per share to manage the position size and recycle capital to more attractively priced areas of the portfolio. Indivior's valuation remains attractive, and management is delivering on their goal of $1+ billion in peak revenue for their flagship opioid addiction treatment drug Sublocade. This goal seems doable and requires reaching 180,000 patients, up from 57,000 as of 1Q 2022 or less than 6% of the estimated of the 3+ million population.

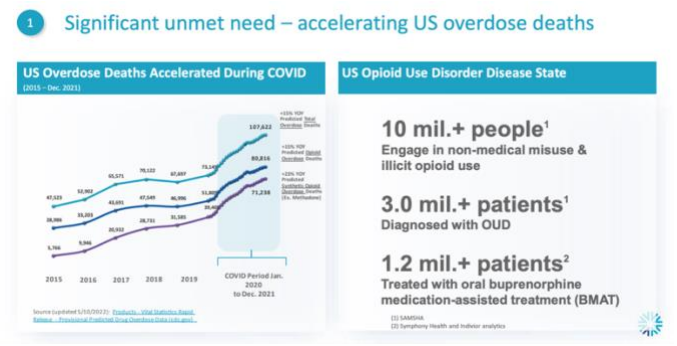
Helping Sublocade's growth has been an easing of COVID restrictions across the US health care systems. In April management estimated that their sales teams now have physical access to 70% -75% of prospects compared to 60% in January.

<u>What is Sublocade?</u>

Sublocade is the first buprenorphine-based long-acting injectable for the treatment of moderate to severe opioid addiction. The drug is pre-filled in a syringe embedded under the skin and released automatically to block the rewarding effects of opioids.

<u>Opioid-related deaths are rising, the "treatment gap" is widening</u>

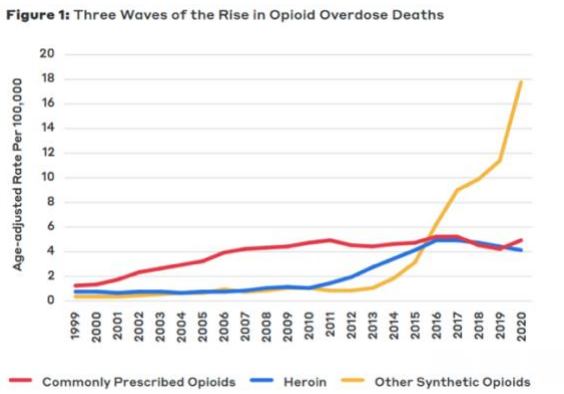
The CDC estimates that drug overdoses have caused more than 107,000 deaths in the latest 12-month period, with 80,000 of those deaths related to opioids, or 219 deaths per day. There is an estimated 10 million people using opioids, 3+ million people diagnosed as addicts, and 1.2 million being treated with oral buprenorphine. [1]



Source: Indivior Presentation

[1] Indivior 1Q 2022 presentation

Synthetic Opioids such as fentanyl addiction is skyrocketing



Source: CDC

Recognizing the acute need for more SUD treatment funding in light of the opioid crisis, federal policymakers have dedicated additional grant funding to serve people with opioid use disorders, including $500 million in 2017 and **$1.5 billion each year since**.

FTX - private

Given the meltdown in crypto I wanted to share what we know about FTX and how we are thinking about the investment. For those who participated, we have not changed the carrying value of the position because it was never marked up to the most recent funding round value of $33 billion. We acquired our stock at roughly a $1.2 billion valuation which is less than the net cash FTX is reported to have available for acquisitions today. The FTT tokens we received as part of the transaction are trading for about 4x higher than our entry price and closer to where they are marked in the side pocket. The tokens that have been distributed to us have not been sold.

FTX is an example of owning a business growing faster by grabbing market share on terms that were unimaginable just last year.

On July 1 FTX CEO Sam Brinkman-Fried (aka SBF) was interviewed by Bloomberg about his newly crowned status as "lender of last resort" in crypto. SBF did a great job detailing where FTX stands today, how he thinks about acquisitions among the crypto rubble, and the company's strategic priorities. FTX is at the epicenter of whatever is happening in crypto exchanges, please see the below link for a transcription and highlights of the interview:

Bloomberg interview with Sam Brinkman-Fried on July 1, 2022, transcribed and edited by JDP for internal use only

Amazon (-35% in H1)

The Partnership invested in Amazon after the stock sold off due a slowdown in e-commerce and overbuilding warehouse capacity during the pandemic. We think Amazon is selling for slightly above the value of AWS (Amazon Web Services) alone and is materially undervalued.

Usually, we do not invest in the very largest companies in the world because they are not only well understood by now, but mathematically it is more difficult to 3x or 4x on our money considering the starting point of such a large enterprise value.

However, Amazon is an unusual case where despite having a $1.2 trillion market cap and many eyes watching closely, the risk/return seems compelling over the next couple of years, even for a smaller fund like ours. This is largely due to AWS and 'Buy with Prime'.

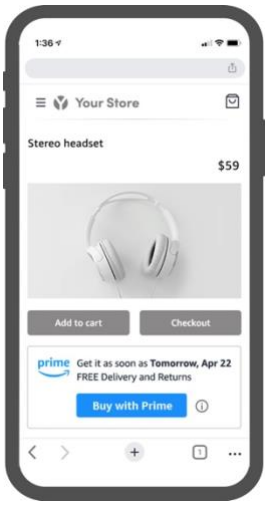
AWS might be the most valuable and important layer of digital infrastructure and protection in the western world today.

AWS is on track to grow more than 30% in 2022 and exit the year with $100 billion in annualized revenue. Years of "unprofitable" reinvestment has led to unmatched scale which is now driving improved operating leverage and unlocking cash flow.

In the first quarter of 2022 AWS's operating profit was up 57% with improving margins of 35.3% compared to 31% a year ago. Over the next five years we think AWS could generate $250 billion in operating earnings while along the path to $500 billion in revenue.

Even if corporate IT budgets decline over the next year or so, AWS is positioned for growth given the business's model of continuously reducing pricing by passing on scale-driven savings to the customer. Additionally, given the state of the world, cloud-related spending, especially on security products from gold-standard providers will likely take priority over less critical boom-time areas of IT spend.

'Buy with Prime' is following the AWS playbook



The market is also giving little if any credit today to CEO Andy Jassy's next major infrastructure as a service (IaaS) vertical that we think is a sleeping giant: Buy with Prime.

Buy with Prime is a service that will eventually let any online seller offer Amazon Prime delivery service to Prime members shopping on non-Amazon sites. Similar to how Amazon sold its cloud infrastructure to outside clients (AWS), 'Buy with Prime' allows Amazon to convert the insurmountable fixed costs supporting Amazon Marketplace into a profit center that consumers can't live without.

Ben Thompson's post "Beyond Aggregation, Amazon as a Service" is an excellent analysis of how Amazon is using the AWS playbook to unlock the next mega business inside Amazon:

"Today Amazon's logistics is massive and fully integrated from the fulfillment center to the doorstep, even though it only serves Amazon; the obvious next step is opening it up to non-Amazon retailers, and that is exactly what is happening…

…Still, every customer that visits these (non-Amazon) websites has an Amazon-driven expectation in terms of shipping; Shippo CEO Laura Behrens Wu told me in a Stratechery interview:

Consumers have those expectations from Amazon that shipping should be free, it should be two days, and whatever those are expectations are, returns should be free. That is still carried over when I'm buying on this branded website. If the expectations are not met, consumers decide to buy

somewhere else…Merchants are constantly trying to play catch up, whatever Amazon is doing they need to follow suit.

…Now Amazon has — or soon will have, in the case of Shopify-only merchants — a solution: the best way to get an Amazon-like shipping experience is to ship via Amazon….

…That business, thanks to the sheer expense necessary to build it out, has a nearly impregnable moat that is not only attractive to all of the businesses competing to be consumer touchpoints — thus increasing Amazon's addressable market — but is also one that sees its moat deepen the larger it becomes."=

Roku (-63% in H1)

"Just as ads evolved decades ago when TV replaced radio as the primary entertainment medium, ads on TV streaming offer new and more performant opportunities than legacy pay TV"
—Roku 1Q 2022 Investor Letter

Roku sells for about 25% less than what we paid in early 2020 when the market collapsed at the onset of COVID. Roku was undervalued then, and now even more so with the leading connected TV operating system in North America and an enterprise value of $10 billion. We think Roku will generate more gross profit than its current enterprise value over the next four years, even if new user growth was to stagnate.

Roku has a long history of reinvesting 100% of its gross profit back into the business at incrementally higher rates of return. The company has compounded gross profit at 57.7% per year since 2015[2].

Roku's user base of 60+ million households is grossly under-monetized, earning about $3.60 per month (1Q '22). As the "dumb glass" TV evolves into a connected, personalized, and interactive tool for next generation of living room advertising, we think the Roku household is worth at least $10 per month in platform revenue. Assuming stabilized R&D costs this should translate to platform operating margins between 20% to 25%, up from ~10% today.

In the first half of 2022 Roku suffered from supply chain disruptions and industry-wide TV unit sales that were below 2019 levels[3]. But now that Roku is arguably fully penetrated in North America, our interest is in the monetization of users, not new user growth.

To that point, despite a slowdown in new users in 1Q, platform revenue was up 39% year-over-year in 1Q. Company developments in the first half that we think are important:

- Roku and Walmart sign historic partnership to sell **shoppable TV ads** (t-commerce). Consumers will be able to click on a product they see in a show and instantly make a purchase on their TV. Viewers will press "OK" with the Roku remote on a shoppable ad and proceed to checkout with payment details pre-populated from Roku Pay.

- The Roku operating system remained the **No. 1 selling TV OS in the U.S.** and gained market share sequentially. The Roku OS was the No. 2 selling TV OS (and the No. 1 licensed OS) in Mexico, where nearly 1 in 5 smart TVs sold were a Roku TV model

[2] 2015 to 2021, SEC filings, JDP estimates
[3] Roku 1Q 2022 Shareholder Letter

- **20.9 billion** hours streamed in Q1, up 1.4 billion hours sequentially. The average active account streamed 3.8 hours per day versus the 8 hours per day of average TV consumption (Nielsen)

- TV streaming devices **surpassed legacy pay TV devices** (Set-Top-Box and DVR) in weekly reach in the U.S., with 65% of adults aged 18-49 streaming TV vs. 63% watching legacy pay TV in March (Nielsen)

- The top 10 broadcast TV advertisers **increased spend on Roku nearly 80%** year-over-year, while spending 7% less on legacy pay TV

- Roku **retained 96% of advertisers** that spent $1M+ and average spend among returning advertisers increased more than 50% year-over-year

Other Positions - Basket of toeholds

In addition to our core holdings, we have a basket of small or "toehold positions" between 1% and 3% of AUM each. We usually only discuss larger positions because their performance has a more meaningful impact on the fund. This time I thought I would mention the toehold basket because I have been asked about how we think about smaller positions and diversification.

Today our toe-hold basket includes our investment in Talas Turkey LP (hitting the cover off the ball this year!), and a half dozen fully researched ideas, mostly micro and small caps, that could be scaled up with incoming capital.

LOOKING FORWARD

In the first half of 2022 many segments of the market were down 70%+, the S&P 500 had its worst performance since 1970, and investor sentiment is at a multi-decade low.

If the last 100 years of US stock market history can provide any benefit of hindsight, it is that periods of world-ending pessimism create extraordinary buying opportunities.

There is not a business where tens of billions, or hundreds of billions in multi-decade value has been created without big macro challenges along the way including inflation, war, recessions, and political uncertainty.

My family's net worth is invested alongside yours and it has been exciting to watch our businesses gain share and get stronger in this environment. But more importantly, prices seem more attractive to me than they have in a decade.

Thank you for your trust and support.

Sincerely,

Jeremy Deal