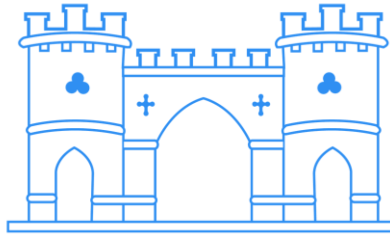
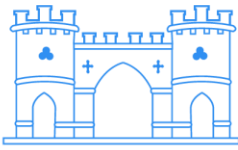


TOLLYMORE

INVESTMENT PARTNERS

A letter to partners, March 2021



TOLLYMORE
INVESTMENT PARTNERS

Dear partners,

Tollymore generated returns of -1.5% in 1Q21, net of all fees and expenses. Investment results since inception are shown below[1]:

GBP	Tollymore (gross)	Tollymore (net)	MSCI ACWI
2016	35.2%	31.4%	26.6%
2017	16.6%	14.4%	13.3%
2018	3.5%	2.5%	(4.6%)
2019	17.2%	15.0%	21.4%
2020	86.9%	77.1%	12.7%
2021 YTD	(1.3%)	(1.5%)	4.2%
Cumulative	252.9%	208.7%	95.3%
Annualised	29.4%	25.9%	14.7%

Collecting red flags

"The only mistakes you can learn from are the ones you survive."

Jim Collins

Tollymore's investment partners are investing in my energy, willingness to learn, pursuit of humility, reasonable judgement, and capacity for focused work. They are not investing in the finished article. My decisions have been, and will continue to be, littered with errors. But investment partners should look for progress. They should look for signs of improvement, of a process that is evolving, while of course remaining faithful to our central philosophical tenets. I hope their willingness to hold me to account will be an important part of Tollymore's ability to generate good long-term results. I hope to aid you in that task through transparent, objective communication. Often my errors of misanalysis are idiosyncratic, but sometimes broader lessons can be identified and internalised to improve our investment process.

In November 2017 I purchased shares of Wonderful Sky, a financial PR services business based in Hong Kong[2] for 1.88 HKD. I exited just over three years later at 0.41 HKD. Our ownership of these shares is comfortably Tollymore biggest mistake, and permanently destroyed 4% of our capital.

One of the barriers Tollymore faces as an 'emerging' investment firm is the shortness of our existence, and the smallness of our 'brand'. Agents acting on behalf of principals when deciding whether to become a Tollymore investment partner face a very real reputational consequence of

[1] Inception 12 May 2016. Source: MSCI, Interactive Brokers, managed account performance in GBP, unaudited, net of all expenses, 1% management fee and 10% incentive fee in excess of a 5% hurdle, as of 31 March 2021.
[2] The detailed thesis was explained in our December 2019 letter to partners.

www.tollymorepartners.com
mark@tollymorepartners.com

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failing unconventionally. I enjoy the challenge of earning the trust of aligned investment partners, and I believe the prize for overcoming this hurdle is stronger investment partner relationships. So, it is indeed a challenge worth tackling.

Wonderful Sky, as an incumbent with a long-established reputation, is a beneficiary of this reluctance to fail unconventionally. Financial PR and investor relations fees for IPOs are a small percentage of the funds raised, but are critical to the successful execution of the IPO. An IPO which only happens once. Given this is not a repeated game, deviating from the market leader is a risk not worth taking, either by the companies being listed or the other service providers who dare not risk their own reputations by recommending a PR firm other than the dominant market leader with the long and successful delivery track record. This lowers customer price sensitivity and allows IPOs to serve as a springboard for a longer-term relationship. Accumulated expertise, relationships, and Wonderful Sky's integrated offering all contribute to switching costs which have preserved the company's excellent financial track record.

But just as I believe that multiple small insights can compound to form a defensible business, so too can multiple small fractures compound to unravel a company's investment merits.

Red flag one: the company's purchase of its office building and swelling fixed income security investments on the balance sheet should have triggered a re-evaluation of capital allocation, stewardship, and alignment of interests. I relied lazily on high insider ownership and dividends to owners multiple times the CEO's salary to mitigate this. As someone who talks a lot about the virtues of first principles thinking, this sloppiness is hard to excuse.

Red flag two: the company issued a profit warning due to a soft IPO market in 2017 and 2018. It should have become clearer that this company's prospects are affected by factors outside of its control.

Red flag three: management cut the dividend to zero, justified by the decline in market conditions. However, the dividend was not reinstated as these conditions began to recover at the end of 2018. I began to engage with management much more intensely to recommend, in concert with other institutional owners, the payment of a large special dividend to address a capital structure that was turning large returns on invested capital into paltry returns to equity owners. While key executives sounded receptive to my pleas, ultimately my words fell on deaf ears. Repeatedly.

Red flag four: as the stock price continued to fall precipitously, I became increasingly concerned about management's economic incentive to take the company private. I engaged with Hong Kong legal counsel to better understand minority protections. It is bizarre that this is the course of action I believed to be in the interests of Tollymore's investment partners. A dispassionate exit, unburdened by loss aversion, would have been a far more valuable decision.

Red flag five (I know...I am so sorry): the final straw came when my interviews with prior executives revealed a potentially decaying company culture.

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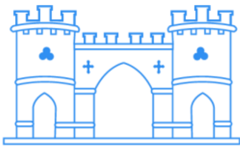

TOLLYMORE
INVESTMENT PARTNERS

This is the opposite of fundamental business progress, and I cringe when I read the updates I made to the investment memo. As the potential value of the company dwindled, upside remained largely unchanged: a classic value trap. I was far too slow to incorporate new information into my appraisal of the company's equity prospects. I collected red flag after red flag, painfully contorting the narrative to justify our continued, and in some instances, increased, ownership. It should have been quite clear to a reasonable observer that business quality had been misanalysed and was deteriorating. Despite espousing the value of intellectual honesty, our ownership of Wonderful Sky was awfully dishonest. I was seduced by extreme cheapness: the company's bizarre capital structure meant that even modest equity declines had extreme implications for business value, resulting in negative enterprise value in the order of hundreds of millions of Hong Kong dollars. In the giddiness of finding this valuation 'anomaly' I lost sight of the core principles of Tollymore's investment philosophy.

Forward execution

I have been somewhat swifter in recent times to exit investments failing to demonstrate positive fundamental business progress.

I acquired shares in Aspen Group (ASPU) in November 2019 for $7.38[3]. I believed ASPU, an online university for degree seeking nurses, was a mission-oriented cost leader in a defensive industry. The provision of federal student loans had disturbed a properly functioning for-profit education market, leading to high prices, poor outcomes, and substantial student debt. This drove a decline in the for-profit education sector of c. 40% over the last decade. But ASPU was bucking the trend, rapidly taking share due to a student proposition that was cheaper and better, absent reliance on federal aid. ASPU benefitted from counter-positioning by offering courses c. 50% cheaper than competitors. Incumbents with flat growth and high profitability were unlikely to match ASPU's prices. We have observed similar incumbent behaviour with the rise of low-cost gyms over the last decade.

Fuelled by a compelling student proposition, large addressable market, and extraordinary unit economics, I believed that ASPU's growth might be very valuable indeed. My thesis was that profitability was inflecting as the business was scaling, and the quoted marketing efficiency ratios were leading to very high revenue-to-profit flow through. Rising operating cash flow supported management's contention that the business was passing through a break even point. Increasing profit margins though 2019 and most of 2020 lent credence to management's presentation of mature cohort profitability. This played out for the first year of our ownership, with the stock rising to a peak of c. $13.

But then came the red flags.

[3] Full thesis explained in our March 2020 letter to partners.

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Firstly, ASPU reported two quarters of widening losses, explained by campus opening delays and a COVID second wave delaying nurses' return to education.

Secondly, the third CFO in as many years left the company, accompanied by assurances this was for personal reasons.

Filing an S-3 was the final straw. If the cash flow reversal was temporary, why raise capital? We exited in March 2021 at c. $6.8. There are absolutely risks to selling, but ultimately execution disappointed and the business stopped demonstrating fundamental progress, undermining the presentation of unit economics and shrinking my conviction.

Lessons

There are some broad lessons I hope to learn from these mistakes and those discussed in prior letters: be less willing to give the benefit of the doubt to management when aggregate economics are not at least directionally supporting unit economics; do not pay to average into businesses with temporary problems, funded by businesses earning the right to be larger portions of the portfolio; be careful when fragmented supply consolidates, and the impact that might have on the utility of aggregation[4]; do not get too close to management, a relationship which may muddy the objective assessment of business prospects; and do not be hamstrung by the label of long-term investor - cutting losses is consistent with maximizing long term value of a group of companies[5].

At least some progress has been made; Wonderful Sky is my only significant dollar error. But the opportunity cost of some of these mistakes has been large, and therefore much value can be gained from not repeating them.

One final note: I am conscious that I owe you a discussion on shrinking value chains. The conclusions of this work have still not fully been expressed in the Tollymore portfolio, but I hope to discuss this enabler of value chain symbiosis in the next letter to partners.

Until then, thank you for your partnership.

Mark

[4] See our previous discussion on TripAdvisor. This is something to watch with our current investment in Farfetch.
[5] I am also open to the idea that I am a very poor micro-cap investor; I will keep an eye on this!

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