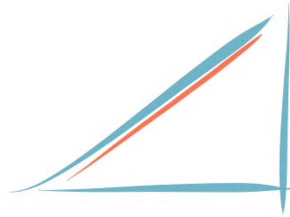


October 2017

Dear Partners and Friends,

Through the nine months ended September 30th, 2017, Hypotenuse Capital Partners, LP gained 16.2% and 12.6% on a gross and net basis, respectively. Our gains have been well distributed across our concentrated portfolio as five separate positions contributed at least 100 bps to the gross return. Our top two gainers each contributed over 300 bps to the gross return. No single position has lost more than 100 bps on a year-to-date basis. Partners desiring a more detailed attribution analysis of our returns should feel free to contact me directly for a more in-depth discussion.

Although I write more extensive analyses of our Fund's positions and activities in my annual and mid-year letters to you, first and third quarter updates are meant to be more concise and therefore I will not here provide as much information about the Fund as you can usually expect in my July and January reviews. However, I did want to take some time to delve into one of several key attributes I seek to identify in our investments as well as reveal one of our previously anonymous holdings. I hope this helps you to develop a deeper understanding of our underwriting, research and thought processes at Hypotenuse.

Deserving Success

What makes an investment successful? There are many factors that can drive the price of a stock higher. Sometimes the fundamentals of the underlying business improve and earnings grow; with such cash flow growth a proportionate increase in valuation is rational. At other times the price of a stock may go up simply because the market grows more enthusiastic or positive about the company. Such shifts in sentiment can drive large swings in the price the market is willing to pay for a company even if the underlying earnings of the company do not change materially. Although it is possible to analyze historical market sentiment patterns, it is nonetheless very difficult to predict with any accuracy when and by how much sentiment will vary. On the other hand, a company's ability to successfully grow its earnings should be eminently analyzable and, in some cases, foreseeable.

How can we know what businesses will be successful before the fact? This is quite literally the million dollar question. Although we can't turn back the clock and invest retroactively, we can study the past to search for clues as to what characteristics will lead to a company's future success and prosperity. One case study that comes to mind is GEICO.

The Flame that Still Burns[1]

> "GEICO, the company that set my heart afire 66 years ago (and for which the flame still burns)." —Warren Buffett, Berkshire 2016 Shareholder Letter

In his most recent annual letter, The Oracle of Omaha reminisces about a car insurance company as if it were a hot crush from his adolescence. While it's not unusual for Warren to wax effusively about a company he admires, his adulation for GEICO goes a step beyond, almost into the realm of romantic poetry. And there is good reason; GEICO, indeed, was like his first love. He first set eyes on the company at the tender age of 20 while studying under Ben Graham at Columbia Business School. So immediate was his infatuation, he soon hopped on a train to Washington D.C. on a winter Saturday and presented himself, unannounced, at the front door of the company's downtown headquarters which was closed for the weekend. Like a star-crossed Romeo, he pined away below the balcony and pounded on the locked front door until a confused custodian finally answered his calls and granted him entry to the chambers within. There he met Lorimer Davidson, who would later become GEICO's CEO, and then the courtship began in earnest.

So hot was Warren's passion for GEICO that, upon returning home to Omaha after graduating from Columbia, he penned a public letter of his affection entitled "The Security I Like Best" which he published in a leading financial periodical. Apparently, Buffett had no problem with long-distance relationships or public displays of affection. He pitched the shares to anyone who would listen and bought a substantial position for his own account over the course of 1951; according to his own records, at the end of that year he held 350 shares accumulated at a cost of $10,282.

As with so many young romances, Warren's initial affair with GEICO was short-lived. He sold the shares in 1952 for handsome proceeds of $15,259 or a 50% gain over his cost. While the profits of this early episode with GEICO were objectively material, Warren himself acknowledges his misdeed here:

> "This act of infidelity can partially be excused by the fact that Western [the interloper that seduced Buffet into dumping GEICO] was selling for slightly more than one times its current earnings, a P/E ratio that for some reason caught my eye. But in the next 20 years, the GEICO stock I sold grew in value to about $1.3 million, which taught me a lesson about the inadvisability of selling a stake in an identifiably-wonderful company."

Warren is understandably harsh on himself for his "infidelity" in this fling as his choice cost him dearly. All was not lost in the relationship though as the two would come together again a quarter of a century later in 1976 when GEICO found itself lost in a quagmire of underwriting losses and teetering towards insolvency. Buffett's friend, Kay Graham of the Washington Post, arranged a

[1] Much of the factual information regarding Buffett's history with GEICO comes from David A. Rolfe of Wedgewood Partners who wrote a wonderfully in-depth paper on the subject. While I am indebted to him for the original source documents and analyses he provided, he deserves no blame for gratuitous stylistic embellishments in this discussion; that burden is mine alone to shoulder. You can read his work at http://bit.ly/2xzHeJs.

reunion of sorts between Buffett and newly-appointed GEICO CEO, Jack Byrne, at her Georgetown home. The tryst rekindled the flame and Buffett was once again buying shares of GEICO the very next morning. Soon Berkshire Hathaway would own over a third of GEICO's shares. A decade later in 1987 Buffett informed his shareholders that GEICO, amongst others, should be considered a "permanent" holding; in other words, "'til death do we part." Finally, in 1995, Buffett committed himself wholly to the relationship and Berkshire Hathaway bought out the remaining shares of GEICO that it did not already hold.

What was it exactly that made the Oracle of Omaha fall so hard for an insurance company? It is one thing for someone to fall for a first love at a young age but to be so adoring of a single company almost 70 years later is a truly unique kind of affection.

The Key to Success

At the core of Buffett's adulation for GEICO is its simple ability to deliver a product to its customers at a substantially lower cost than its competitors. As Buffett explains in his shareholder letters:

> "When I was first introduced to GEICO in January 1951, I was blown away by the huge cost advantage the company enjoyed compared to the expenses borne by the giants of the industry. It was clear to me that GEICO would succeed because it *deserved* to succeed." [The emphasis is Buffett's own.]

GEICO has a distinguishing feature which sets it apart from the rest of the industry: it sells directly to customers. By avoiding the cost of supporting a network of independent commission-carrying sales agents, GEICO has a considerably more efficient operation than other insurers. In fact, GEICO's expense-to-premiums written ratio is approximately 15%, versus 25% for the average auto insurance carrier. This significant cost advantage allows GEICO to price its product at a level that almost no other competitor can profitably sustain. As Buffett explained in 1976:

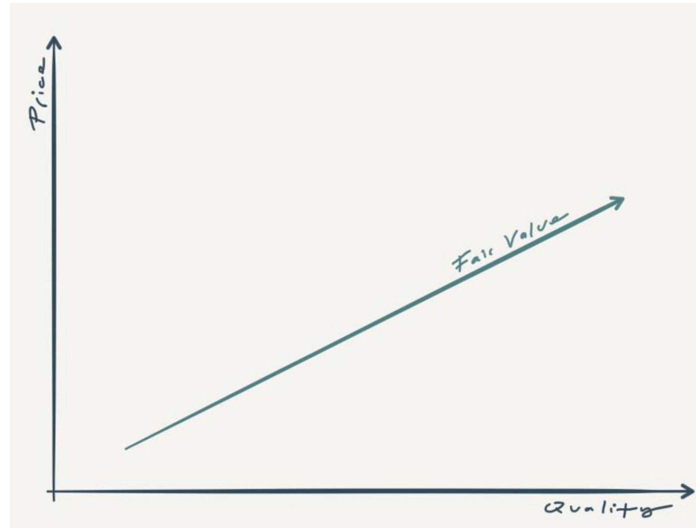
> "I always have been attracted to the low cost operator in any business and, when you can find a combination of (i) an extremely large business, (ii) a more or less homogenous product, and (iii) a very large gap in operating costs between the low cost operator and all of the other companies in the industry, you have a really attractive investment situation."

I will note that although GEICO is an industry leader when it comes to cost, the company doesn't just skimp on quality. According to insure.com, GEICO receives customer satisfaction ratings of 94 and 89 for claims experience and customer service, respectively. 87% of reviewers would recommend GEICO to a friend. GEICO's product is not only low cost but also high quality.

Deviant Behavior

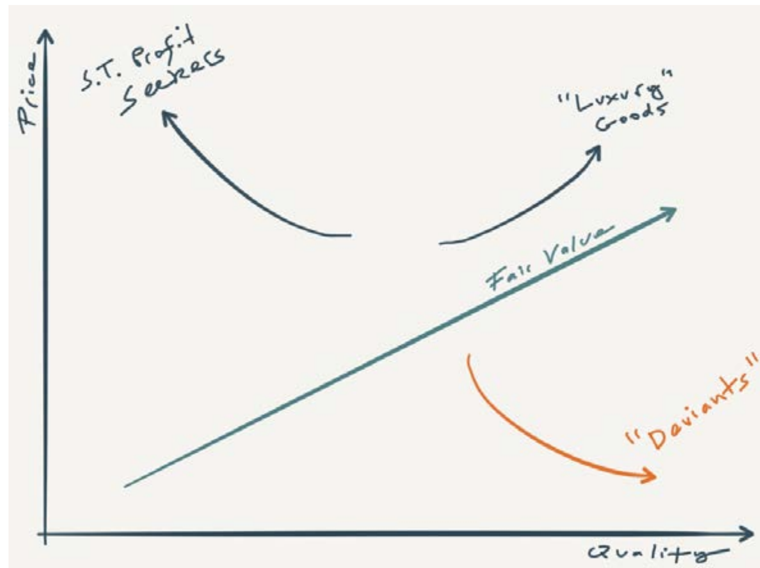
Of course, the relationship between price and quality has always been a useful framework for people looking to buy something. This is why websites like Yelp, TripAdvisor and Amazon are so popular: it's extraordinarily useful to know the quality of a product or service prior to

purchase. And generally, one expects that as a product's quality increases, so too does its price. Thus, if one were to plot a two-dimensional chart with quality on the x-axis and price on the y-axis, one would expect that a line representing a given product's expected price would be upwardly sloping to the right as quality increases.



Now, an inherent tension exists in that a typical business that is trying to maximize profits in the short-term is incentivized to raise prices but lower costs. Of course, it is difficult to cut costs without sacrificing quality. Hence many firms tend to migrate towards the upper left-hand quadrant of the chart (low quality, high price). This is a rational decision for any firm trying to maximize profits in the short-term but it creates challenges over the long-run since no one likes to pay a lot of money for a shoddy product.

On the other hand, there are companies that pride themselves upon crafting extraordinarily high quality products and will charge exorbitant prices for them (think of luxury goods makers like Hermès). Economists and business school professors might argue that this is the mark of a successful firm: significant pricing power and the ability to realize above average profit margins and returns on investment.



It is entirely understandable and common for firms to move ***up*** the price dimension of our chart; conversely, firms that try to move ***down*** the price dimensions are rare, and even more unusual are the firms that do so ***while also*** moving to the right on the quality dimension. Such companies are "deviants" in a competitive world typically obsessed with expanding profit margins. Yet this is the domain where GEICO operates and it is a fundamental driver of why the company has been so successful. This commitment to providing a high quality product at a bargain price is an unusual ethos but one that drives a decidedly virtuous cycle. Customers who buy a high quality product at a low price delight at their fortune of getting a good bargain. They return as repeat customers and recommend the product to their friends. As such a company grows and benefits from economies of scale; the deviant can continue to offer ***even lower*** prices and even better service, thus allowing it to capture even more market share. This ability to march down and to the right on the cost-quality curve creates an ever widening and durable moat which competitors cannot cross. Deviants make their money not by squeezing every last penny of margin out of any given customer and supplier, but by operating at extraordinarily low margins where the competition ***cannot follow***. The scale benefits rewarded to deviants by happy customers makes it still harder for competitors to retrace a deviant's footsteps. Deviants may sacrifice profits on an individual unit basis but make up for it in sheer volume.

Today, GEICO is a powerhouse within the insurance industry. GEICO is the second largest auto insurer in the nation with 12% market share, which is up from 2.5% when Berkshire took control of it in 1995. GEICO is creeping up on the country's leading auto insurer, State Farm, which has about 18% share. GEICO wrote $26 billion in premiums in 2016 up from $21 billion just two years prior. GEICO provides a hoard of cash for Buffett to invest in the form of its $17 billion float while *also* operating at an underwriting profit. GEICO's continually increasing success is undeniable and very much "deserved."

There are other examples of deviant low-cost high-quality ethos companies who have earned dramatic success. Consider Costco, which by rule will never markup merchandise more than 14% above cost and earns less than a 1% pretax operating margin on its retail sales, even on "luxury" items like fine wines, handbags and diamonds. Today, Costco has a fanatical

membership base and is one of the most successful and prosperous retailers in the world. Think of Southwest Airlines, which started as a misfit regional air carrier serving just three cities in Texas, and became one the largest air carriers in the U.S., all based on the proposition of providing a wonderful flying experience at a lower price. Contemplate the prosperity of fast food chain In-N-Out Burger, which for decades has provided freshly made, never frozen hamburgers at an absurdly low cost. To this day, the queues for the drive-through at In-N-Out often snake through the parking lot and spill into the street. These companies have earned the right to succeed because the deviant ethos of low price, high quality is a winning one-two knockout proposition for the consumer. In short, these companies deserve to succeed and consequently have delivered remarkable returns for their owners.

Most companies try to find ways to make their stock prices go up. Many of them do so by trying to grow profits by lowering costs and raising prices. A few might be pushing the boundaries of higher quality but still expect higher prices as a reward for their efforts. It takes a contrarian mentality to steer a business down the deviant path of lower prices while offering higher quality. Such players are forgoing profits in the near-term to win over the long-term. They don't get fat off of excessive margins but rather reinvest in delivering superior value to their customers. They stay lean and run ever faster on behalf of their clients. These are a unique and rarely seen breed. Not every successful company will be a deviant, nor will every investment we make fall under this criteria; yet when deviants do present themselves, they can prove to be astoundingly successful businesses and, by extension, wonderful investments.

Two Deserving Cows

Tucows Inc. is a business that deserves to succeed. Headquartered in Toronto, Canada, Tucows has three lines of businesses. The company's domain services business is the second largest internet domain registrar in the world, and manages over 29 million internet domain names. The company's Ting Mobile division is a Mobile Virtual Network Operator (or "MVNO") that provides voice, data and text messaging services for mobile devices. Ting does not own its own cellular network; instead, it rents bandwidth capacity through T-Mobile and Sprint, which it resells to its own customers. The company's third division, Ting Internet, is building high speed fiber optic data networks in several towns across the U.S.

Each of Tucows three divisions qualifies under our "deserving success" framework of high quality/low price product.

For example, the domain registry business offers extremely competitive pricing on internet domain registration. At Tucow's hover.com registration portal, a one-year domain registration costs just $13. A comparable package at market share leader godaddy.com costs $20 or 50% more than the same service at Tucows. You can save an additional $2 on your next domain by going to https://hover.com/iOOXtmEG.

The average Ting Mobile user pays just $23 per device per month. Ting is able to keep its costs low by charging customers for only what they use. The initial line charge is just $6 per device per month. Buckets of 100 minutes of talk time, 100 text messages and 100 MB of data are all priced at just $3 each. As long as customers keep their usage low, their monthly bill is also very

low. Consequently, Ting willingly teaches its customers how to minimize utilization through techniques like disabling apps such as Facebook from using cellular data and restricting such traffic to Wi-Fi only. While national carriers like Verizon are offering unlimited plans, these start at $75 per month for a single line. Consequently, the potential for customers to save money by switching to Ting are quite substantial.

Ting Internet is just beginning to roll out across a handful of towns in the U.S. The basic value proposition is simple. Ting selectively and efficiently builds fiber optic networks in towns like Charlottesville, VA and Centennial, CO. They expect the networks to cost approximately $2,500 in upfront investment per customer. Ting will provide customers with 1 Gb/s symmetrical upload and download internet access for $89 per month. By comparison, Verizon's Fios advertises half the bandwidth that Ting does (500 Mb/s) at over twice the price ($195 per month).

Meanwhile, in addition to providing attractive prices to consumers, Tucows also provides high quality service. Customers rave about Tucow's friendly and responsive customer service. Calls to the company's help desks are often picked up on the first ring by a live person who solves the customer's problem within minutes. The company prides itself on not forcing customers to plod through automated directory trees, or to suffer through bad hold music. This effort shows up in customer satisfaction surveys; Ting Mobile has a net promoter score of over 70 while most mobile network operators score less than 20.

Tucows has a lot of room to grow. Although the addressable market for mobile devices in the U.S. is several hundreds of millions of devices, so far Ting Mobile has signed up just 280k devices on its service. Ting Internet is rolling out in five towns with an aggregate population of less than 400k residents. However, winning a mere 100k fiber accounts would double Tucow's current consolidated operating earnings. Meanwhile, Tucows continues to look for additional towns to add to the Ting Internet community; there are over 100 mm households in the U.S. There is ample of room for Tucows to continue to win additional market share in its businesses.

Tucows is spearheaded by an exceptional leader in CEO Elliot Noss who inspires his employees with a simple mission: "to provide simple, useful services that help people unlock the power of the Internet." Employees are passionate about the customer-oriented and mission-driven culture. The company is sensibly capitalized with low debt to cash flow (debt/EBITDA ~2x). Noss has been consistent about returning capital to shareholders; the company has repurchased 50% of shares outstanding over the past decade. All of these data points suggest that Tucows is well positioned for future business success. I am very optimistic about what the future holds for Tucows.

An Oracle and his Gecko

A parting observation about GEICO's deserved success revolves around its reptilian spokesperson, who has also earned Warren Buffett's affection and admiration. Buffett wrote in his 2014 shareholder letter:

> "Our gecko never tires of telling Americans how GEICO can save them important money. The gecko, I should add, has one particularly endearing quality – he

> works without pay. Unlike a human spokesperson, he never gets a swelled head from his fame nor does he have an agent to constantly remind us how valuable he is. I love the little guy."

The witty lizard certainly does seem like the ideal employee. However, given that he is a computer rendering, perhaps it's not really that remarkable. What is remarkable is the resemblance the gecko bears to another important Berkshire Hathaway employee: the Chairman himself. Consider that Buffett has worked for over five decades at a nominal salary ($100k annually) with no bonus, and no equity grants or stock options. He's never complained about the size of his paycheck and certainly has never called on an agent to negotiate his contract. Despite his fortune and fame, Buffett keeps a low profile and his ego in check (how many billionaires still drive themselves through the McDonald's drive-through on the way to work every morning?). Buffett's adoration of the gecko is well-placed but Buffett himself certainly did more than his fair share to position Berkshire itself to succeed.

Organizational Update

Over the past few months we have continued this year's trend of admitting new Partners to the Fund. Apart from writing these letters I devote very little of my time to marketing. Therefore I am grateful that more of you have taken the step to entrust me with your assets without the need for a "hard sell" process. This has allowed me to focus most of my time on finding and researching the best opportunities in which to deploy our capital intelligently so that we can enable our aspirations. I thank you for your trust and support.

As I mentioned in my previous letter, although we are currently open to admitting new Partners, such will not be the case indefinitely. Our capacity to do so will ultimately be limited by operational and regulatory constraints. If you or someone you know would be interested in securing one of the remaining spots in the Fund, please reach out to me directly for subscription information. As a reminder, all Partners must be accredited U.S. investors.

I hinted in my 2016 annual letter that I am evaluating potential structural improvements to position the Fund for continued success. This is still a work in process, so please stay tuned. The objective is to make Hypotenuse a Partnership that *deserves to succeed*.

I remain committed to enabling our aspirations while protecting and growing our capital over the years to come. Should you have any questions concerning the Partnership's activities or your account, please do not hesitate to reach out to me.

Warmly,

Michael J. Lee

mlee@hypotenusecap.com
818-210-5060

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