Year	MPE Capital (qualified, net)	MPE Capital (non-qualified, net)	S&P 500 TR
2017[1]	17.7%	18.9%	18.6%
2018	0.9%	-0.2%	-4.4%
2019	7.5%	7.3%	31.5%
2020 H1	10.8%	11.5%	-3.1%

[1]Inception January 25, 2017

Portfolio Holdings (alphabetically)
Alphabet
Booking Holdings
Brembo S.p.A.
Credit Acceptance Corp.
Wix.com Ltd.

July 7, 2020

2020 First-Half Letter

Dear Investors,

MPE Capital generated net returns of 11.5% for non-qualified clients and 10.8% for qualified clients for the first half of 2020. Our benchmark, the S&P 500 TR, declined 3.1% during the same time period. Just a reminder that we do not sell short, nor do we utilize leverage.

First and foremost, I hope you and your loved ones are staying safe and healthy during this global pandemic. 2019 finished off with the S&P gaining over 30% and the global economy firing on all cylinders. I don't think anybody expected—and certainly nobody predicted—that during the first quarter of 2020 a virus was going to quickly spread throughout the entire world and bring the global economy to its knees. This event is just another reminder that predicting macroeconomic events is a futile endeavor. *Nobody* knows what the economy and stock market will do in the short-run.

Since that nobody also includes me, I prefer to focus on individual business analysis. During the first quarter of 2020, many businesses went on sale, and like a teenager black Friday shopping—I scooped up many new investments at bargain prices. Something I had to consider that I never really had to consider before was how long a particular business could survive with zero revenues. All the businesses we bought during the first half of the year had plenty of liquidity and could easily survive one to two years without any revenue.

I’m a proponent of using a discounted cash flow approach to business valuation. A business is worth all the cash it will produce for its owners over its useful life, discounted back to today at a reasonable interest rate. In following this approach, if you knock off some cash flows in the early years, it doesn’t mean the business is worth half of what it was worth before. Yet this is exactly how the market was pricing some businesses during the first quarter.

For example, a business earning $1 million per year that won’t grow at all is worth $12.5 million (assuming an 8% discount rate and long-run capital expenditures equal to depreciation). If that same business earns nothing in its first year of purchase but returns to earning $1 million per year thereafter, it is worth $11.57 million. That’s a 7.4% decline from before, a far cry from minus 50%.

During early 2020, many businesses could be purchased for half-off just because they might have one or two difficult years. Some of these businesses had tremendous balance sheets with ample liquidity and enduring competitive advantages. Some will even be worth more because of this recession, as competitors will fall by the wayside, thus leaving them with less competition and greater share. Airbnb is a large competitor to Booking Holdings (one of our holdings). They ran into some serious troubles and had to raise a lot of cash in order to continue operating. Some other smaller competitors might not be so lucky, strengthening Booking Holdings competitive position.

WIX

One business we purchased during the first-half of 2020 is Wix. I have been a customer for years and have always thought it to be a great business. Their primary offering is a do-it-yourself website builder. Regardless of your proficiency in computers, they make it easy to create a professional website. They even have a more sophisticated version (Corvid) for users who want even more customization.

If you want to see high switching costs in action, take a look at Wix’s cohort data. Once customers put in the time to develop a website and become a premium subscriber, they tend to stick with Wix for years and years. Wix also benefits from economies of scale, as they can leverage the research and development of new offerings across a large number of subscribers.

The current CEO is a co-founder, something I like to see. Founder chief executives generally are very passionate about their businesses and most prioritize the long-term as opposed to next quarter’s results. The CEO’s brother is also a co-founder and has been with the company since inception. Co-founder Giora Kaplan was CTO since inception but recently stepped down. Management owns a fair amount of stock, which helps align their interests with ours as passive shareholders.

Wix is a high growth business reinvesting the majority of its cash flows back into the business. Valuation is a little more difficult due to all the income statement growth capex. They have grown revenues at a 40% annual rate over the last five years. Even during the COVID-19 crisis, first quarter 2020 revenues grew at a rate in excess of 20%. I believe the key drivers for Wix are

the number of premium subscribers and revenues per subscriber. They have almost 5 million premium subscribers and about 175 million registered users who are not yet premium subscribers. Over time these registered users have a tendency to convert to premium customers.

Over the next five years, I'm forecasting that they will grow revenues at around 20% per annum. Current operating margins are negative, but I consider the majority of their sales and marketing spend (S&M) to be growth capex. Adjusting for the S&M spend and some more fixed cost leverage, I get a normalized steady state operating margin north of 30%. They also have a very healthy balance sheet with over $900 million in cash as of the first quarter—more than a year's worth of revenue. I started buying at around $83 per share, hoping to buy more as the stock went lower. I wanted some more margin of safety due to the lower certainty I have in the valuation. Unfortunately, the stock didn't go lower, but the good news is we are up three-fold since the purchase.

BREMBO

Another new addition to the portfolio is Brembo S.p.A., an Italian manufacturer of brake calipers and discs. Brembo was established in 1961 by Emilio Bombassei, the father of the current chairman Alberto Bombassei. An automotive supplier is not usually a company I would invest in due to how cyclical the industry is, but Brembo is an exceptional business with a highly differentiated offering. They have earned an average return on equity capital of 20% over the last ten years, and even generated positive operating income during the global financial crisis.

They are a supplier to all the leading automotive original equipment manufacturers, including Ferrari, Daimler, Aston Martin, Tesla, and Volkswagen. The majority of premium automobiles have Brembo brakes. They also supply to commercial vehicle and motorcycle manufacturers. Brembo is also a large supplier of brakes to racing cars, including Formula One.

I believe their main competitive advantage is economies of scale. Their high market share and high plant utilization rates allow them to leverage fixed costs over millions of units. They are also able to leverage their research and development spend over many units, allowing them to create superior products. They also have plants all over the world, giving them the ability to manufacture parts very close to their customers. This combination of superior product and lower relative cost is what allows them to enjoy multi-decade relationships with many leading automotive original equipment manufacturers. Brembo's close relationship with racing teams also allows them to stay on the cutting edge of technology.

The Bombassei family are large shareholders (53% of the shares outstanding) and Alberto seems very passionate about the business his father founded. He is very much focused on pushing the envelope with regards to brake technology.

Due to the fact that the business is cyclical, valuation becomes a little more difficult. The business has very little debt and plenty of liquidity; they should have no problem weathering a steep decline in the production of new autos. I'm forecasting mid-single-digit growth rates over the next five to ten years and returns on incremental capital of 20%. I think an intrinsic value of

around €12 per share seems very reasonable, and we purchased shares at a healthy margin of safety to that number.

FIRST PERMANENT CAPITAL LOSS

I think in sharing all the successes, it's only fair to share a failure as well. We registered our first case of serious permanent capital loss in the first quarter of 2020. I purchased an active investment manager in early 2018 at what I originally estimated to be a discount to intrinsic value. I figured there are decent switching costs, most of their funds had beaten their benchmarks, and lots of employees owned stock.

As for valuation, I assumed the business would grow at least mid-single digits even if they don't get much inflows, due solely to the organic grow in their portfolio holdings. They also had and continue to have a very healthy net cash position, with tons of marketable securities.

Now onto what I believe was the main mistake: not enough focus on the key business drivers. I was overly focused on assets under management (AUM). But AUM is just one driver, another key driver is the advisory fees they earn on those assets. I failed to notice that this rate had been declining, and that decline has only accelerated. I believe this is due to the rise of low-cost passive alternatives, as well as their poor performance over the last few years. When you couple top-line advisory fee pressures with compensation costs growth of mid-single digits, operating profits start feeling a lot of pain. This decline in operating profits is what lead to an impairment in intrinsic value and subsequent capital loss for us.

After this mistake, I've learned to focus very closely on identifying the key drivers of any business I'm evaluating. I then ensure that I can forecast those key drivers with a high amount of certainty. A business that takes oil out of the ground and sells it is uninvestable for me because of this very reason. A key driver is oil prices, something I don't believe I have any ability to forecast. Forecasting business performance is not easy, and once in a while I will be wrong (hopefully not too often). This is why I always try to employ a margin of safety in case the future doesn't turn out to be as rosy as I'm expecting. This is also why we don't put all of our money into one idea.

Fortunately, we had ample opportunities during the first half of the year and so we sold this investment manager below intrinsic value in order to reinvest the proceeds in a business of superior relative quality and lower relative valuation.

CONCLUDING THOUGHTS

The businesses we own have enduring competitive advantages, excellent balance sheets, and are run by passionate and competent management teams. They should all survive, if not thrive during this period of uncertainty while smaller less capitalized competitors close up shop.

I'd like to close by thanking you all again for entrusting me with the allocation of your capital. I'm glad that no clients panicked during these past few months. In fact, some clients even added capital to their accounts.

I hope you and your loved ones stay safe and healthy until we can get to the other side of this pandemic. Hopefully the healthcare industry surprises us all with a vaccine soon enough. I look forward to updating you on our full year results at the turn of the new year.

Sincerely,

Michael P. Ershaghi

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Past performance is not indicative of future performance. Inherent in any investment is the possibility of loss.

Indices are provided as market indicators only. It should not be assumed that holdings, volatility or management style of any MPE Capital investment vehicle will, or is intended to, resemble that of the mentioned indices. The comparison of this performance data to a single market index or other index is imperfect because the former may contain options and other derivative securities, may include margin trading and other leverage, and may not be as diversified as the S&P 500 Index or other indices. Index returns supplied by various sources are believed to be accurate and reliable.

Fee assessment began July 25, 2017 due to state registration approval. Client results will vary slightly due to separately managed account structure. Performance numbers assume you were a client since the inception date. Qualified client fees are a 1% fixed management fee, and a 10% performance fee subject to a high watermark. Non-qualified client fees are solely a 2% fixed management fee.