

Investmentaktiengesellschaft für langfristige Investoren TGV

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Dear Investors

We are enclosing the shareholder letter for our Teilgesellschaftsvermögen “Partners Fund” for the first half of 2018 written by our sub-advisor MSA Capital GmbH.

Yours sincerely

Investmentaktiengesellschaft für langfristige Investoren TGV

Vorstand: Jens Große-Allermann, Waldemar Lokotsch
Aufsichtsrat: Dr. Maximilian Zimmerer (Vors.), Wolfgang Fritz Driese (stv. Vors.), Alexander Pichler (stv. Vors.)
Eingetragen im Handelsregister Bonn HRB 16143
Investmentvermögen mit veränderlichem Gesellschaftskapital

Bonn, July 2018

Dear Investors,

The share price of the Sub-Fund (TGV) Partners Fund as at 29 June 2018 amounted to EUR 147.78. Thus, the change in value within the first half year of 2018 including all costs was + 4.68%. The DAX achieved a performance of - 4.73% over the same period.

| Year | TGV Partners Fund (1) | DAX (2) | Difference Δ (1-2) |
|--------------------------------------|-----------------------|-----------|---------------------------|
| 2015 (9 months) | + 1,48 % | - 10,22 % | + 11,70 % |
| 2016 | + 15,95 % | + 6,87 % | + 9,08 % |
| 2017 | + 19,97 % | + 12,51 % | + 7,46 % |
| 1 st half 2018 (6 months) | + 4,68 % | - 4,73 % | + 9,41 % |

| | | | |
|-----------|-----------|----------|-----------|
| per annum | + 12,77 % | + 0,87 % | + 11,90 % |
| total | + 47,78 % | + 2,84 % | + 44,94 % |

Even though the result for the first half year looks smooth at first glance, the prices of the companies in the TGV Partners Fund have developed very differently. There were considerable fluctuations in the portfolio. The spread between positive and negative performance of individual companies in the first half was higher than in the past.

Let me explain some of the drivers of the reported stock performance in the first half of 2018:

The shares of **TripAdvisor** and **amaysim** have progressed in distinctly opposite directions. While TripAdvisor increased its value by about 65% after announcing better-than-expected operating results in just six months, amaysim's shares have been significantly impacted by a continued price battle in the Australian telecommunications market. The share price plummeted by half over the past six months. This drop alone caused a loss of around 8 % of the total assets of the TGV Partners Fund.

Although the oil price has developed well in the current year, and after several years of crisis, companies are sending positive signals in their operational business again, shares of companies in the oil and gas industry rose only moderately. Currency developments had minimal impact on the performance of TGV Partners Fund during the first two quarters of the year.

The high fluctuation within TGV Partners Fund is likely to be maintained in the future. It is due to the concentration on a few, but carefully selected companies. As emphasized on several occasions, high market volatility is inevitable, and the TGV Partners Fund prefers a high return, generated with fluctuations, over a lower return achieved without fluctuations.

The companies in the TGV Partners Fund

Of the twelve companies, the TGV was invested in on 06/29/2018, as usual, I list the ten largest positions in alphabetical order:

- Admiral Group
- amaysim
- Gruppo MutuiOnline
- NOW
- TripAdvisor
- Alphabet (Google)
- Grafenia
- National Oilwell Varco
- Rolls-Royce
- Tucows

These ten companies represent approximately 90 % of the fund's assets. The largest company the TGV is currently involved in has a market capitalization of around 700 billion Euros, the smallest of approximately 10 million Euros.

The central investment principles of the TGV Partners Fund have not changed and will not change in the future. When recommending potential investments, I remain committed to the following criteria:

- 1) Does the company have a reasonable business model?
- 2) Does the company have a lasting competitive advantage?
- 3) Does the management act rationally, with integrity, and does it consider the shareholders to be partners?
- 4) Can we purchase the company's stocks at a reasonable price?

Changes in the top 10

Since the turn of the year, there has only been one change within the portfolio. The **Microsoft** position was sold after a little more than three years holding period, and instead, we purchased shares of **Grafenia**. This change had less to do with the quality or a change in the prospects of Microsoft, than with the perception of an opportunity that rarely arises in this shape or form.

Microsoft has been an integral part of the portfolio since the inception of the TGV Partners Fund and has contributed very positively to performance over time. The transformation that Microsoft has gone through in recent years under CEO Satya Nadella is spectacular and anything but a matter of course. Just a few years ago, Microsoft was seen as a sluggish, monopolistic, one-product company with a penchant for sub-par products. Steering such a behemoth with over one hundred thousand employees – all too accustomed to decades of profit from the Windows monopoly – in a completely different direction within just a few years is a considerable entrepreneurial achievement.

As noted in the outlook for the first half year of 2016, the TGV Partners Fund has the possibility to focus on investing when there is a particularly good opportunity with a low inherent risk. It can also invest in the smallest and/or illiquid companies if the associated disadvantages and risks are compensated appropriately.

This moment has come in May of this year when the TGV Partners Fund subscribed to a block of shares of the British company Grafenia as part of a capital increase. The funds needed for this were drawn from the sale of our Microsoft position. In terms of its market capitalization, Grafenia is a tiny company whose shares are traded only sporadically. Without the purchase of a larger share package during the rights issue in May, the acquisition of the shares in the market would have taken many months, if not years. For traditional investment funds, Grafenia represents a company that is almost “un-investable” due to its illiquidity.

Grafenia

Furthermore, the investment in Grafenia can also be described as an exceptional situation, and I am very curious to see how the company will develop over the next few years.

Founded in the early nineties as "Printing.com" in Manchester, Grafenia's beginnings were those of a print/copy shop where leaflets, business cards, or flyers could be printed and duplicated. After the IPO in 2000, the company expanded boldly in the UK and had 300 locations at one point in time.

The technical changes of the past twenty years have been responsible for catastrophic conditions in much of the printing industry. This environment made all market participants including Grafenia fight a constant uphill battle for survival. In the last ten years, Grafenia's business has been rarely profitable, and stocks have lost three-quarters of their value.

For several years, Grafenia has been investing heavily to become more independent of the traditional printing business. In September 2014, Grafenia launched "Nettl", a software-based service that helps independent graphics and print shops to quickly and easily create websites, web shops, or other web services upon customer request. Today, after just a few years, the company has over 130 so-called Nettle partners, and many of the old Printing.com licensees are switching to the new system.

These changes also reflect the prevailing realities of small and mid-sized enterprises. 20 years ago, a business card was one of the first things a start-up entrepreneur needed, a space that is now taken over by websites. In Nettle shops, small and mid-sized businesses can get everything they need to start their operation from one source. In addition to creating a website or a web shop, Nettle also helps design and produce business cards, advertising material, or signage. Nettle also offers help improving visibility by search engines, such as Google (Search Engine Optimization, SEO for short).

The driver of this change and the new momentum is above all the team headed by CEO Peter Gunning. The team has done a fantastic job reviving their own business in recent years. Peter has led one of the first Printing.com stores and knows the industry like the back of his hand. Since the spring of 2016, this change has been accompanied by Jan-Hendrik Mohr, a longtime friend and outstanding entrepreneur. I cannot imagine a better lineup for the coming years.

The capital increase in May 2018 was undertaken from a position of strength. Grafenia has taken over several small companies since 2017 and is convinced that it will be able to reinvest much more capital in this area. Considering the fact that the costs of a stock market listing in the UK are very high and fixed, and the returns on acquisitions seem excellent, this is a double positive effect.

There is no doubt that there are high risks associated with investing in Grafenia. The market environment in the industry and the general situation in the UK continue to be difficult, and the business model is still in transition. However, these risks are more than compensated by the people involved, good underlying circumstances, and the very high potential.

The only downside of the investment is that it will be difficult for the TGV Partners Fund to buy more shares of Grafenia in the future due to illiquidity. This means that any future new partner in the TGV will likely dilute the existing share of your position. After much deliberation, I decided that this fact should not hinder an investment in Grafenia. However, it will mean that after further inflows of funds in the TGV Partners Fund, Grafenia will no longer appear among the ten largest positions, as it already represents the smallest position among the top ten companies.

The value of existing customer relationships (“Customer Lifetime Value”)

A concept that has become increasingly important to me in recent years is to accurately analyze and understand the value and leverage of a single customer for a business. This consideration, generally referred to as Customer Lifetime Value, is a key that opens the lock to understanding many businesses.

While this logic is commonplace, especially among venture capital firms, I have the impression that the value of customer relationships is relatively often misunderstood in the stock market, and seemingly high valuations are regularly dismissed as ludicrous, although they maybe are well justified.

A company’s balance sheet usually includes capitalized assets such as real estate, machinery and equipment, inventory, software, or receivables. In contrast, self-generated customer relationships cannot be found there. However, it is undeniable that a customer who uses, for example, software with a contract that can be terminated without notice, on average switches software only every ten years. So this customer represents a very high value for the company that offers this software.

Furthermore, the income statement regularly captures costs for creating such a customer relationship. However, in the same income statement, these costs are not offset by the value that will be generated by the acquired customers in the future. Thus, a situation can arise in which a company creates extraordinarily high value through the meaningful acquisition and retention of long-term customer relationships, which is discounted by low profits or even balance sheet losses at present.

Amazon is a prime example of this logic because Amazon invests in its customer base like no other company. Today, more than 100 million customers are registered with Amazon Prime and regularly spend more on the Amazon universe than non-Prime customers do. This customer base has tremendous value, although Amazon only has little profits on paper.

The values that have a pivotal impact on the customer’s lifetime value are essentially the gross profit generated over the entire term that the customer stays with the company and the costs incurred for acquiring a customer and making the offer available on a permanent basis.

Today, many companies seem to be expensive when assessed based on their static results. For many of these seemingly expensive companies, however, a closer look and taking into account their existing customer base paints an entirely different picture.

In times of the Internet, this is true today more than ever. The structure of software business models and the ever-increasing penetration of the Internet into all areas of life have a particular impact on this logic. Understanding these relationships is of paramount importance to an investor today.

One fact that is typical for software business models is that the marginal costs incurred per additional customer are low. A software, once programmed and stored on a hard disk, can be replicated any number of times without incurring costs. Previously, physical data mediums were needed to duplicate and distribute software. Today, the use of software through the Internet is theoretically and often practically possible without any marginal costs.

The costs of launching a company operating exclusively on the Internet have been falling rapidly for years. Driven by ever faster and more stable data connections, so-called cloud computing also means that today, many applications do not even have to be installed on your own computer.

The fact that virtually every citizen of the world is a potential customer and the absence of marginal costs create the basis for spectacular and historically unprecedented economic outcomes. The well-known venture capitalist Marc Andreessen ascribes the reason why *“software is eating the world”* to this phenomenon.

This explains, at least in part, why, for example, a very fast-growing company such as **Salesforce.com** with overwhelming market potential, extraordinarily long-term customer relationships, high and growing revenues as well as gross revenues per customer, and vanishingly low fixed costs is already so extraordinarily valuable.

However, Salesforce's profitability has been low for years. Many market participants may wonder where to find value there but based on the logic described above, the mechanism at work can be easily clarified.

The key to understanding low profitability is sales and marketing expenses. They are necessary for customer acquisition and represent by far the largest cost block. Due to its outstanding market position, the company would probably still grow without these expenses, albeit more slowly – most likely reporting a multi-billion-dollar profit.

That these marketing expenses are obviously proactively controlled, can be derived from the highly recommended book "*Behind the cloud*" by the cloud pioneer and founder of Salesforce.com, Marc Benioff. The low profitability is, therefore, a deliberate decision because the marketing costs of several thousand US dollars per acquired customer are outweighed many times over by the future customer value. In this case, investing in customers is an entirely sensible and profitable investment in the future. Low profitability today is outweighed by future returns.

Whether the company is now a cheap investment given its market capitalization of around USD 100 billion is an entirely different story. What is certain, however, is that a company like Salesforce cannot be valued in a meaningful way based on today's profitability or book value per share. Valuable and intangible customer relationships make a value that is much higher than the "hard", tangible values actually present in the balance sheet.

The previous considerations on existing customer value are also used by numerous companies in the TGV Partners Funds. Be it **Rolls-Royce** engines, **Admiral Group** insurances, **Ting** fiber optic connections (by **Tucows**), or **National Oilwell Varco** spare parts regularly replaced on oil rigs worldwide. The existing customer value is a vital component of the intrinsic value of many of the companies in the TGV Partners Fund, which is rarely found on the balance sheet.

Especially with the Australian company **amaysim**, the considerations of the customer's lifetime value were of central importance in the past half year.

amaysim

As a result of an escalating price battle in the Australian communications market, amaysim has come under pressure in the last ten months. How brutal the situation is can be seen, for example, from the fact that in June, **Telstra**, the counterpart of **Deutsche Telekom** in Australia, announced that it would lay off a quarter of its employees.

Today, amaysim has just over 1.1 million mobile customers and just under 200,000 customers in the energy sector. Let us assume – in a very simplified scenario – that customers in the energy sector have the same value as when amaysim acquired Click Energy about a year ago. Back then, the mobile sector taken on its own was valued at about AUD 100 million at its low. This equates to a valuation of just under AUD 100 per existing customer.

In the past and on average, amaysim's customers stayed for over four years before switching providers. Historically, amaysim has grossed AUD 7-8 a month with an average customer.

Spread over four years, a gross profit of about AUD 350 was achieved, of which, in turn, slightly more than half (around AUD 175) remained with amaysim as operating income. On average, amaysim has

spent roughly AUD 25 to win a new customer in recent years. An excellent ratio with a high internal return.

Following the above logic, amaysim has recently been valued at a mere AUD 100 per mobile customer. Apparently, the market was in an utter panic that not only the profitability of the future but also today's customer base would suffer permanently from the price battle.

However, if amaysim's mobile phone segment stopped acquiring new customers entirely and customers behaved as they historically have for the next four years, the existing customer base alone would be more valuable than the stock market valuation.

This fact does not even take into account that many of amaysim's operational measures and customer-centric focus give hope that the number of customers could actually grow. For example, in other countries, the bundling of multiple products (mobile, energy, and broadband Internet) has proven to have a very positive effect. Moreover, it has led to a dramatic increase in the customer retention time, which has a decidedly positive impact on the above logic and customer value.

However, it is clear that the extreme price battle will leave its mark on the customer's lifetime value. So an investment still depends on how the market situation develops. At the moment, almost all participants in the market get a bloody nose. The history of such price battles shows that after a while, for the most part, certain rationality returns. Only very few market participants can permanently accept losses.

Can the battle last longer than expected? Yes of course! However, compared to all other wireless market players, amaysim has the lowest cost to acquire and serve customers in the day-to-day business. A price battle is, of course, extremely ugly in the short term – but unlike for many smaller MVNO market participants, it is not lethal for a company like amaysim.¹

If the price battle continues in the medium term, the existing customer base is a critical asset. It may also be of strategic interest to the existing network providers to better utilize their own capacity. There are numerous precedents around the world for how price battles and developments in the area of mobile communications have developed. I know of no case in which the existing customer base of the largest MVNO would not have had an acceptable value.

Therefore, I am confident that an investment in amaysim will make a positive contribution in the medium and long term despite a catastrophic short-term price trend. I am very curious how this chapter is going to evolve in the future. Of course, I will keep you up to date.

With this in mind, I wish you a beautiful summer and thank you for your continued trust.

Kindest regards from Bonn,

Mathias Saggau

¹ amaysim is an „mobile virtual network operator“ (MVNO) in Australia without an own network. This business model is quite common in different countries and has an long term relation with the second biggest Australian network Optus.