

Ryan Reeves · Oct 4, 2023 · 12 min read

Q3 2023 Letter

Dear partners,

Thank you for your continued trust and support. As I reflect on the past year, I've been studying our biggest losers and have noticed these have been unprofitable companies that tend to be the smallest allocations in the portfolio. These are companies with substantial upside if everything goes well, but also more downside. To that end, we've cut all stakes in businesses without profits and have concentrated into the companies where we have the highest conviction. To be brutally honest, I have dug ourselves into a hole and I've lost many nights of sleep over it but I sincerely believe that concentrating in our best, most resilient companies will be the best way forward. It's unwise to try to gain it all back at once as that will likely exacerbate things. I don't take this responsibility lightly and, at the moment, it feels like I'm failing. With that said, I am still, I maybe surprisingly so, confident about the future and the quality of the companies we hold. I am eager to focus on the road ahead, using this past year as an immense learning opportunity, laying the foundation for decades of success. Thank you once again for your support; it truly means the world. I won't forget it.

In our first year of quarterly letters, we've detailed our philosophy and some specifics around how we maintain high standards to create the portfolio. It's simple but not easy to pay reasonable prices for companies that can exponentially grow their free cash flow over a long period. Everything else could be considered an abstraction compared to the ratio of the multiple you pay and the free cash flow growth that you receive. But what I've come to learn is that the abstractions do matter because they directly affect your conviction in the business. If I pull up a screener with the lowest EV/FCF multiples and the fastest 5-year FCF CAGRs, it's mainly a list of biotechs that got a large milestone payment, shipping companies, and energy companies. I wouldn't consider most of these high quality businesses. So it's important to curate a list of the highest-quality businesses – those that are defensible and have the potential to maintain high growth for an extended timeframe – and then figure out the earnings growth/multiple ratio.

To that end, we have a database of about 700 companies that have been profiled and sorted by the qualitative and quantitative factors we look for. As we learn more about a company, the scores get tweaked, resulting in a robust ranking process. We don't necessarily make all of our decisions based on this ranking system, but it's a great way to determine how we spend our time. The lowest-ranked companies don't deserve our time unless something significant has changed in the business. It's also a great filter so we can easily discard a new idea. This database will only grow stronger as the years go by and it's, by far, our most valuable piece of intellectual property. Nearly every high-quality company you can think of has been profiled and added to the database, even slower-growing companies like Fico, TransDigm, Cintas, LVMH, Rollins, Old Dominion, or Copart. While it's true that lower-quality companies can outperform because anything can be a good investment at a cheap enough price, we prefer to focus on the best of the best for several reasons. One, time is on your side. With a low-quality business, you usually can't have a long-time horizon since the business value isn't compounding at a high rate. After you get the multiple mean reversion, it's typically time to move on. Two, the more decisions we have to make, the more opportunity for error. I would far prefer to do nothing for a long time, until there is a tremendous opportunity. Activity for the sake of activity isn't fruitful in the craft of investing. Three, the benefits that accrue to the leading companies are consistently underrated. The smartest people want to work at those companies which leads to better products, happier customer experiences, higher margins, and more reinvestment. Four, there is a reasonable amount of knowledge arbitrage when you have long holding periods. If you're constantly adding and subtracting new companies, your level of knowledge likely isn't that deep on a company. As a counterpoint, this can easily lead to the endowment effect, which can be blinding when you do need to move on. None of this is revolutionary investing knowledge, but it's a reminder, mainly to myself, that time is on the side of the quality business.

To stick with the theme of the first four letters, let's now put our lesson into practice as we dive into another portfolio holding.

Shelly Group

The Shelly Group is a Bulgarian company that started as a telecom but has since narrowed its focus to IoT devices, mainly in the home automation space. The company recently changed its name from Allterco as its product line, Shelly, now accounts for the vast majority of the business.

The company makes most of its money from selling small chips, called relays, that allow customers to automate certain functions in their homes. This involves physically integrating the chip into the electrical outlet wiring and then using Shelly's app to tie everything together. Shelly also sells dimmers, lights, and dozens of other products related to home automation.

The Numbers

Over the past 12 months, the company has done just over \$60 million in revenue and over the past 6 months, grew 53%. Gross margins are over 50%. In Germany, Austria, and Switzerland (DACH), the company is growing well over 100% and this makes up nearly half of revenue. A relay device sells for as low as \$19 on Amazon but the US accounts for less than 10% of revenue.

The company predicts it can grow sales over 40% for the next three years, to over \$220 million by the end of 2026 and bring in more than \$55 million in EBIT by that time. That's a bold prediction and there is no guarantee those numbers are achieved but that is the standard management is holding themselves to.

Free cash flow conversion oscillates because the company typically builds inventory in the back half of the year with the Black Friday/Holiday season. However, the company is firmly free cash flow positive with a rock solid balance sheet of about \$20 million in cash with no debt. Dilution is basically non-existent and the company doesn't need to tap capital markets as it is self-funding with no plans to do large, empire-building acquisitions. The company will occasionally do small tuck-ins like the recent GOAP acquisition for a little over \$3.5 million.

Market Size/Optionality

The market is sizable. IoT devices can be applied to industrial and commercial settings, not just home automation. The company recently announced a large customer agreement with Vodafone. The telecom operator will use Shelly's products to monitor their energy usage in Africa, with intentions to roll out across all of Vodafone's geographies. And we're not just talking about energy efficiency. The company's products are already integrated into some large irrigation systems that have seen great success with Shelly's automations.

Shelly estimates there are 39 million households in the EU that could use its products right now, growing to 93 million by 2027. As of now, the company is about 4-5% penetrated based on its 2 million household reach. These estimates only include the EU and don't give much credence to the industrial and commercial markets either. Shelly could easily reach its 2026 goals and still be nowhere close to market saturation.

Moat/Competition

One reason for the company's growth is the very high energy prices in Europe. Shelly products enable customers to save on their energy bills. You can basically automate everything you can think of in your house and it's all compatible with current home automation systems. You can set up your sprinklers, your lights, your coffee maker, your fridge, anything that plugs into the wall. And then you can automate it through the app and here is a real differentiator versus competitors – through Javascript. There is a whole Shelly Academy that teaches users how to write scripts to do all sorts of unique automations.

Further, Shelly integrates with Alexa, Google Home, Zigby, Z-Wave, Wifi, Matter, Bluetooth, and pretty much any other home automation technology. The low cost of the hardware and the flexibility of the software is really at the core of the competitive advantage. Shelly has sold over 9 million devices across 2 million households. The average Shelly user has between 4 and 5 devices but the power users, the top 50k customers, have nearly 25 devices! These folks have wired their entire houses, from garage doors to blinds to appliances and everything in between. Once this system is set, however, there is no recurring revenue so Shelly recently started a freemium model in its app. For a couple bucks per month, this new app enables users to get more data on energy usage, with personalized recommendations on how to save even more energy. Management has made it clear that this likely won't be a huge revenue line item but it could provide a profitability lift in the future.

The thing that investors have to get comfortable with is the competitive advantage. Other than the fact that the company is illiquid and based in Bulgaria, this is likely the real crux of why some investors may be wary of this name. As bears point out, the hardware is fairly commoditized but the orchestration layer through the company's software is where I believe the advantage lies.

The closest competitor in Europe is probably Plejd, which is Swedish. The company is a little bit smaller but has a very different distribution model. It only sells through licensed electricians because it is actually illegal to do your own wiring in Sweden. The government deems it too dangerous and therefore all electrical installations are done professionally. This means that the average Plejd relay is at least 2x the price of Shelly products. Installers can pocket a little extra money and users are typically less price sensitive when a professional is doing the installation.

Last quarter, Plejd grew only 3% compared to Shelly's 46% growth, despite Shelly doing about 20% more in quarterly revenue. One reason for the Plejd weakness is the slowdown in home starts in Sweden due to interest rates. Naturally, a large portion of Plejd's business comes from electricians doing big automation jobs on new homes.

This leads into one small advantage that Shelly has – its online communities. Since there is some friction in getting the relays set up, there is a tight-knit community where people help each other. For example, there is a Facebook group that has about 75,000 members and the engagement in the group is quite impressive. And one thing I love is that the CEO/co-founder can regularly be found answering questions.

Further, the company is continually looking to deliver value. It is creating an improved chip, manufactured by Espressif, that will lower costs and run on Shelly's new operating system. This pairing of a new chip and a new software backbone should make it far easier to connect to multiple home automation systems, improving the customer experience. Once again, the combination of very low cost hardware and customizable software is the foundation of the competitive advantage.

Risks

Shelly is certainly not a bulletproof business. The hardware is fairly commoditized but the fact that the company is creating its own chip and operating system are a clear differentiator from the competition. The fact that gross margins are mid-50% with mid-20% EBIT margins are strong pieces of evidence that the company's products are not commoditized.

Second, the product is also not super simple to set up. If you look at the Google Play reviews, there are dozens of 1 star reviews talking about how the app's UI is terrible and how adding new devices was incredibly difficult. The overall score is 2.6 stars out of 5, which worries me a little bit. That's why I'm very bullish on the professional installer market which is multiples of the size of the DIY market. Compared to Plejd, it will be an incremental market for the people who want automation but don't want to fiddle with their electrical outlets. It's easier to go from the consumer market – and already having the organic online tutorials – to the professional market, rather than the other way around.

Third, the company is fairly reliant on Chinese manufacturers, especially Espressif. This is a risk that is worth recognizing as global supply chains haven't been nearly as robust as we've become accustomed to. Management is aware of this and is working towards building redundancy in other regions.

Management

Dimitar Dimitrov and Svetlin Todorov are the co-founders of the original business, Teracomm, a telecom business that was founded in 2003. Both of these guys still run Shelly and they each own 32% of shares outstanding. They have worked together in communications for 20 years and now they are fully focused on the IoT business.

There are really two phases of the co-founders' careers. From 2003-2013, it was Teracomm. Then they started Allterco, the IoT business. Teracomm was later sold in 2018 and that's when Shelly really started to take off.

In 2021, they brought in the current CEO of Shelly Europe, Wolfgang Kirsch. He's a retail/consumer electronics guy and he's done a pretty good job so far with stocking European growth. Dimitrov is the overall CEO but he is mainly focused on R&D. He is the main technical one of the three top executives. Todorov recently became the CEO of Shelly US, which is based in Las Vegas. It's an interesting move that signals the company is more serious about the US market than the current numbers would suggest.

Valuation/Summary

If the company can hit its current goals, it will be doing more than \$55 million in EBIT in three and a half years. On a \$380 million enterprise value, let's say they just beat the \$55 million goal to get to \$60 million. That would be less than 7x EBIT. But, of course, that's three and a half years away. A lot could change. Actual performance could fall short. Competitors could come in. Management could drop the ball. But let's run through a back-of-the-napkin 5-year model.

Let's say the company hits the \$220 million goal by the end of 2026 and then grows 15% for the next two years, a far cry from the 4 year 45% CAGR growth they would've put up. That's about \$290 million in revenue. At 30% EBIT margins (management expects these), that's \$87 million. Even at 10x EBIT, that's a 18% CAGR from here.

At 15x FCF, it's the same CAGR if we assume a 10% (20% FCF margins) haircut from EBIT through to FCF for taxes and working capital.

Shelly is creating a very strong home automation brand in Europe. The company's growth and margin profile certainly suggest that the products aren't commoditized. While there is a perception that it's a simple hardware business, the combination of being a low cost producer, coupled with the most customizable, open software makes the company a formidable competitor. Management is continually improving the product and despite very little marketing efforts, the growth of the online communities and the resulting revenues have been impressive. Meanwhile, the current valuation leaves room for more upside as the company executes its plan.

Closing

I'm honored to have you as a partner. Thank you for your trust and support. It enables me to think long-term and will be our own competitive advantage.

The stock market, like life, will have its ups and downs. All we can do is focus on what we can control and work hard to continually raise our standards. Our strategy is simple – hitch a ride to the world's best entrepreneurs that are running the fastest-growing, highest-quality companies at the most attractive valuations we can find. Here's to many more years of focusing on the inputs and letting the outputs take care of themselves.

Sincerely,

Ryan Reeves

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Performance Appendix

Net Returns	Infuse Partners LP	S&P 500
Q3 '22	-10.85%	-13.39%
Q4 '22	-22.21%	7.09%
Q1 '23	10.06%	7.04%
Q2 '23	0.40%	8.29%
Q3 '23	-8.52%	-3.65%
Since Inception	-29.90%	3.59%

Letters

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Q1 2025 Letter

Dear partners, Thank you for your continued trust and support; you are the best partners I could ask for. This quarter, I want to talk a...

Q4 2024 Letter

Dear partners, Thank you for your continued trust and support; you are the best partners I could ask for. As we wrap up the year, I...

Q3 2024 Letter

Dear partners, Thank you for your continued trust and support; you are the best partners I could ask for. After two years of running...

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