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Letter to investors, Q2 2024

Performance

As reported by our fund administrator, the Master Account, in which I am personally invested alongside SMA clients, returned -2.7% net in Q2 2024 vs 4.3% for the S&P500. As of June 30, 2024, the top ten positions comprised approximately 66% of the portfolio, and the portfolio held approximately 16% in cash.

	QTD	YTD	1-year	3-years	5-years	Inception
ACML	-2.7%	4.2%	16.3%	-1.1%	2.9%	5.8%
S&P500 TR	4.3%	15.3%	24.6%	10.0%	15.1%	17.2%

ACML performance is net of fees and standard costs.

Refining Our Strategy: Better Risk Management and Portfolio Adjustments

Candidly, the portfolio's returns have not met my aspirations. As a dedicated steward of our capital, I am committed to learning and improving the investment process. I am all the more motivated because I have a substantial portion of my capital invested alongside clients.

The good news is that I have spent considerable time analyzing past decisions and have concluded that a large part of the issue has been with risk and portfolio management. There are several actionable steps I can take which I believe will make a difference from now on:

1. Protect the downside while still allowing winners to run
2. Be more willing to change my mind if the thesis changes or has drifted
3. Be more nimble to take risk off investment and conversely to get back in if the situation warrants
4. Differentiate better between the few companies that are true compounders and those that are merely attractive risk/reward

I'll explain more, but I also hope to clarify that this is intended to improve risk management and not a wholesale change in how I invest. I desire to seek out long-term compounders at attractive valuations and resist over-trading, for the benefit of after-tax returns.

Protect the downside. Overall I have made some good picks that have been successful investments. Fairfax, KKR, Google, Amazon, and ESAB come to mind. On the other hand, to present a balanced view, a handful of names have detracted meaningfully from overall performance. Liberty Broadband, Cirata, Alliance Data Systems come to mind. Just mathematically, the losses from these situations have made a dent in the returns of the overall portfolio. As with the baseball analogy, it is the slugging percentage (number of winners x amount of wins less number of losers x amount of losses) that matters. I have modeled actual past decisions made, and the conclusion is that if I had been more willing to cut losers sooner, it would have significantly improved returns, even with the extra tax and trading costs. One must be careful with any form of back tests and with generalizing future expectations, as it is easy to say in retrospect that one could or would have done things differently. Still, the differences in returns would have been significant.

Be more willing to change my mind. The question is, why might I have let these losses become large in the first place? My strategy focuses on owning quality companies with attractive prospects at compelling prices, often taking a contrarian view and then waiting patiently for the market eventually to recognize the actual value of these companies. As a student of value investing and from private business ownership, I have internalized the idea that we are looking at the business fundamentals to inform our opinion of value, not the daily gyrations of share price. I have a predisposition to study a company's fundamentals carefully, take a long-term view, establish a position, and then do very little. The theory is that all businesses face temporary headwinds, and having the patience and stomach to look through temporary drawdowns allows good companies time to work out the issues, markets to normalize, and stock prices to eventually recover and match.

As Yogi Berra famously said, "in theory there is no difference between theory and practice. In practice, there is." In practice I have found that if a position starts to move against me, it should be a call to re-assess and re-examine my assumptions. It could be that the market is responding to a large shareholder selling for uneconomic reasons, general market dislocations not specific to the company, a reaction to temporary difficulties, or a reaction to a more severe impairment in the company's prospects, such as increasing competition. Or it could be that my thesis was wrong from the start. The biggest detractors to performance came when a company exhibited all the hallmarks of a potential compounder, but I was too slow to adapt to changing competitive circumstances, choosing to give the company more time to work out its issues and buying into the rhetoric of a founder-led management team, all while the investment lost more of its value.

Be more nimble. This brings me to the third point—it is perfectly OK to cut risk if the situation becomes cloudy or uncertain or if my conviction starts to wane. One of the advantages of the public markets is their liquidity. While we endure volatility, I can also be nimble in lightening up on a position and preserving capital. Importantly, this works both ways in terms of getting back in should further developments restore confidence in a company's prospects.

To be clear, I am not talking about reacting to every share movement or short-term quarterly earnings "beat or miss." That is not the game we are playing. Instead, it's a call to be more responsive in re-underwriting the thesis on a position to determine if a company has been impaired or if the thesis has drifted.

Differentiate between the true compounders and the rest. Competitive forces are such that very few companies can compound value for decades. I'm reminded of that Bessminder report (referenced in earlier letters) that only 4% of stocks produced all the net dollar wealth creation in US equity markets from 1926 to 2019. It is often hard to know which will be successful compounders from the outset of an investment. While I will continue to strive to let winners run as long as they can, it is OK to exit a profitable investment after its course has run. Over time, even the singles and doubles can contribute meaningfully to overall performance.

With the above in mind, I made the following changes to the portfolio this quarter.

I exited Enovis. On paper, their strategy of carving out a niche in foot and ankle niche and expanding to Europe through acquisitions is intelligent, allowing for potential cross-selling opportunities. Nevertheless, it is a relatively small company facing stiff competition from industry giants like Stryker and Zimmer, who have significant advantages of scale, large budgets for product development (such as robotics), extensive sales forces, and established platforms that surgeons have already trained on. It is less clear to me that Enovis will "win" and it appears to have additional headwinds managing an extensive integration, including "negative synergies" from overlapping sales channels with its newly acquired companies.

I exited Wayfair, which has been a challenging investment from the beginning. While the valuation appears cheap, and their logistics buildout for handling bulky packages is impressive, I am less optimistic about their mid-term growth prospects. They face intense competition from Amazon, Home Depot, Target, and other specialty retailers like Restoration Hardware and IKEA in a cyclical sector where brand loyalty is less pronounced. Furthermore, despite having a founder/operator management team theoretically aligned with shareholders, Wayfair needs more

cost discipline. Even with their recent focus on cost control, I am increasingly concerned about their excessive share dilution.

Exiting IAC was a difficult decision because I value their management team. I have been encouraged by their success with the MGM investment, progress at DotDash, and the potential at Turo. The team has a strong focus on intelligent capital allocation. However, Angi continues to face significant challenges. Management is making commendable efforts to turn the business around and has restored profitability, but I cannot say with conviction that it will be successful. Additionally, I have begun to question IAC's overall strategy of consistently spinning off successful businesses. While this may address the holding company discount issue, IAC is often left with less successful or mature businesses to develop, and building a business is inherently risky with a high failure rate, but by design IAC chooses to embark on this difficult journey each time.

I trimmed positions in Burford and Cogent. Burford's shares gained following the appointment of Javier Milei as President of Argentina, amid expectations that his sweeping economic reforms would increase the likelihood of Argentina settling its debts, including the \$16 billion YPF case, on which Burford has a large claim. However, the excitement has waned without significant news, and different judges in different districts have issued conflicting rulings on a large case with Sysco. Meanwhile, their quarterly earnings have been steady but unremarkable. Cogent's integration issues have been more challenging than anticipated. The company must complete building out virtually all of its CNDCs, which will not happen before year-end, to determine if its new waves revenue stream will be as large as expected. In the meantime, it has missed its \$100 million waves revenue target by a wide margin, and its core business (broadband to large corporate offices in skyscrapers) remains below historical averages. For both Burford and Cogent, the market is not forgiving of these types of "misses," and the fact remains that these new revenue streams are unproven, though potentially significant if they succeed. Risk mitigation seemed appropriate, and in both situations, I stay open to re-entering in size should positive developments arise.

Portfolio – top and bottom performers¹

Top Performers	Contribution	Bottom Performers	Contribution
Prosus NV	0.98%	Burford Capital Inc.	-1.06%
Alphabet Inc	0.74%	Enovis Corp.	-0.67%
Fairfax Financial Holdings Ltd.	0.60%	Exor NV.	-0.56%
KKR & Co Inc.	0.49%	Carmax Inc.	-0.52%
Amazon Inc.	0.45%	ESAB Corp.	-0.52%

As calculated in the Master Account brokerage statement.

Prosus

Analysts spend considerable time dissecting Prosus' net asset value through detailed sum-of-parts calculations and charts of daily buyback transactions. Management has encouraged this focus, and under intense shareholder pressure to address its discount to Tencent, they have emphasized their actions to simplify the corporate structure and share repurchases—significant at over 22% of outstanding shares in the last two years. Yet, the NAV discount persists. Prosus's year-to-date share price performance was driven almost entirely by Tencent, which has posted

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strong revenue growth in domestic games and ads. I expect Tencent's robust pipeline of games to launch later this year will continue this momentum.

However, Prosus appears to recognize the limitations of financial engineering. The recent elevation of Fabricio Bloisi, CEO of iFoods, to group CEO is a clear signal of a strategic shift towards operations. Mr. Bloisi's background in computer engineering and his success with iFoods position him well to tackle challenges at Delivery Hero, another major holding, as a first step, with the potential to extend this approach to the rest of the group. While he may have less experience in investor relations, Kevin Tu, CIO with a background in investment banking, is likely to provide support. In the meantime, I remain invested due to a combination of factors: Tencent's resurgence, Prosus' renewed operational focus, and the continued profitability of its e-commerce subsidiaries.

Alphabet

Alphabet continues to perform strongly, with 16% revenue growth, with particular strength in search (14%), YouTube ads (21%), and Cloud (28%) and near-record operating margins of 31.6%. Viewed just a few months ago as a vulnerable incumbent facing stiff competition from OpenAI and others, sentiment around Alphabet's competitiveness in GenAI has turned more positive. Previously, some worried that Large Language Models (LLMs) could bypass traditional search results, potentially impacting ad revenue from third-party publishers. However, Alphabet has started incorporating "AI Overviews" in searches featuring responses from its LLM and Gemini. It reports improved user satisfaction and click-through rates exceeding those of traditional web listings. Alphabet believes AI will expand its search monetization and is exploring new features like short product videos, virtual try-on options, and 3D product views within shopping ads. It has also rolled out AI tools for advertisers, such as enhanced image creation and improved measurement, to refine the advertising experience further. Alphabet benefits from a strong competitive moat due to its vast infrastructure, including data centers, custom chips, and leading LLMs like Gemini. This infrastructure allows them to seamlessly integrate AI across their products, reaching billions of users. However, their projected capital expenditure of \$50 billion this year, primarily for tech infrastructure, is worth monitoring. While financially manageable, it signifies a shift from Alphabet's capital-light past to a more capital-intensive approach in the AI era.

Fairfax

Fairfax continued its track record of consistent performance this past quarter. It acquired the rest of Gulf insurance, which is now consolidated on its books, which contributed to a healthy 11.8% year-over-year growth in net written premiums (excluding Gulf, the increase was still a solid 5.3%). The company maintained a strong combined ratio of 93.6%, though I note this metric might be impacted going forward as we enter hurricane season. Interest and dividend income exceeded management's estimates, reaching nearly \$600 million for the quarter and putting the company well on track to achieve its \$2 billion target for the year. Fairfax has extended bond duration and increased its allocation to corporate bonds (approximately 15% of total bond investments) to get more yield. Eurobank and Poseidon provided the bulk of dividends from associates. The company's commitment to shareholder value remained evident with \$260 million deployed in share buybacks.

KKR

In an environment where "realizations" (exiting investments and earning carried interest on gains) have been challenging, KKR's advantaged platform and business model have continued to perform strongly. On the institutional side, it has capitalized on rising interest rates with robust fundraising in private credit and infrastructure funds. In the increasingly important wealth management channel, KKR recently signed a deal with Capital Group to target the mass retail markets. Capital Group, managing approximately \$2.7 trillion in assets, has a strong distribution network in the retail channel and focuses on growing its Target Date Funds and actively managed ETFs, which aligns with KKR's strategy. The initial product offering will be a hybrid liquid/private credit vehicle, with KKR managing the private credit portion and Capital Group managing the public portion. Anecdotally, as an investment advisor, I have noticed a marked increase in demand for private investments. This trend bodes well for KKR's wealth channel, as it now has drawdown funds targeting the high-net-worth segment, its K-series funds targeting the "mass affluent," and now a strong partner to penetrate the retail channel.

Amazon

In his annual letter to shareholders, CEO Andy Jassy underscores Amazon's commitment to "primitive services" over the last 20 years – creating foundational building blocks that empower rapid development of higher level products and services. Examples include developing core functionalities like payments and search, which eventually led to the Fulfilled by Amazon service, or developing logistics infrastructure, which led to the Buy with Prime service. Amazon is adopting the same approach to the next front, GenAI, from custom AI chips and training/deployment services to empower companies to construct their own core GenAI models, to their Bedrock service which allows customers to use pre-existing models to more quickly develop applications, to Amazon developing their own applications for internal use (think Alexa and a new shopping AI called Rufus).

Amazon's dominance comes not just from its scale but also from a relentless “customer obsession,” exemplified by its focus on building services that empower customers. This positions Amazon to capture significant shares of the growing retail and cloud markets. With a 45% share of online retail, which only makes up 25% of total retail sales, Amazon is well-placed for growth. The company's expansion into the grocery sector, backed by investments in same-day delivery, shows promise. Currently, Amazon holds a 20% share of the grocery market, a segment that constitutes 34% of US retail sales but is only 12% penetrated. As online retail trends towards 40-50% penetration, Amazon's growth potential is meaningful. Similarly, in the cloud sector, only 10% of IT spending has shifted to the cloud, with AWS holding a 35% market share.

Burford and Enovis – as discussed above

Exor

Exor's investment in Phillips has proven timely. The latter settled faulty sleep apnea lawsuits for \$1.1bn vs. the \$3bn expected by the market, with the share price rallying approximately 27% on the news. Exor increased its shareholding to 17.51% from the initial 15% acquired in August 2023. The Philips investment is part of Exor's plan to invest in healthcare, luxury, and technology and diversify away from its historic focus on automotive.

Ferrari is making impressive strides. The company has consistently traded at a premium, which aligns somewhat with the idea of valuing it more like a luxury brand than a carmaker. However, this premium valuation seems to contradict the inherent tension between maintaining exclusivity and expanding the business. This is being addressed through two major initiatives. The launch of its SUV, the Purosangue, and the opening of its 42,500 sq. “E-Building,” which will produce all future eclectic cars, including hybrid and ICE. These initiatives will allow Ferrari to venture into new market segments while preserving the exclusivity of its flagship sports cars. Stellantis, on the other hand, operates in a highly complex, capital-intensive, and competitive industry, currently undergoing significant shifts due to the rise of electric vehicles. Despite these challenges, Stellantis owns robust brands like Jeep, Ram, Fiat, and Peugeot, is focused on reducing costs by 30%, while launching new products, and developing profitable electric vehicles. The company is cash flow generative, with an expected €8 billion in cash flow in the second half of the year, and its stock is attractively priced at a low single-digit P/E ratio.

Exor now receives approximately \$1.2 bn in dividends from its largest holdings against a market capitalization of approximately €22bn, which allows for significant flexibility in strategic capital allocation.

CarMax

CarMax, previously a winning investment for us, has disappointed us recently. As per the discussion at the start of this letter, I am re-underwriting my thesis carefully. Two key factors impacted CarMax: the rise of online competitors like Carvana and franchised dealerships entering the used car market and a post-pandemic environment with higher financing costs and less affordable cars. Their traditional brick-and-mortar, no-haggle model, while successful historically, faced challenges. In response, CarMax invested significantly in omnichannel offerings and technology to enable efficient car sourcing from consumers and dealers in a supply-constrained market. While this

strengthens their long-term position, it has put temporary pressure on profits. Moreover, CarMax prioritizes consistent margins per car (~\$2,500), which has impacted sales volume in recent quarters compared to competitors focused primarily on sales growth.

The used car market will eventually normalize, which should lead to positive operational leverage in CarMax from its recent investments. The company benefits from long-tenured management that has successfully navigated difficult macro conditions before. Management has shown adaptability with the omnichannel rollout and willingness to experiment with auto financing for lower-credit customers. I am carefully assessing the risk-reward against cash and other opportunities that I am looking into.

ESAB

I remain confident in ESAB's long-term prospects. Since its spin-out from Colfax, the position has generated a significant return of approximately 1.9x. The recent share price weakness is primarily driven by broader market factors impacting industrial stocks since May. ESAB's key competitors in the welding oligopoly, Lincoln Electric, and Illinois Tool Works, have also experienced similar share price declines. However, as highlighted earlier, I closely monitor performance to mitigate potential downside risk and guard against round-tripping returns.

New Position:

Terravest Industries Inc.

Terravest is a C\$1.3bn market capitalization company based in Alberta, Canada, rolling up storage tank (propane, fuel, water) and boiler/furnace companies, run by a well-incentivized management team focused on good capital allocation. Terravest trades at a reasonable mid-teens free cash flow valuation, unlike many well-known serial acquirers.

The storage tank industry is surprisingly profitable, offering high returns on capital and proving to be a better business than one might have expected. Terravest operates four divisions:

- Compressed gas equipment (e.g., LPG and propane tanks), essential for rural home and commercial heating and agriculture (crop drying, etc.). 30% of sales and 24% of EBITDA at 16% margins.
- HVAC (industrial, commercial, and residential fuel tanks, wastewater tanks, furnaces, and boilers). 29% of sales, 30% of EBITDA at 20% margins.
- Processing equipment (wellhead procession equipment) near natural gas and biogas production facilities. 18% of sales and 13% of EBITDA at 14% margins.

Service (water management) servicing and close to LNG producers. 24% of sales, 33% of EBITDA at 27% margins.

The company has a strong history of growth through acquisitions. It currently operates 25 businesses and has made 20 acquisitions since 2013. Terravest typically uses debt to fund acquisitions, primarily of mom-and-pop companies, bought at an average 5.5x FCF multiple, then uses the cash flows of the acquired businesses to pay down debt.

Following the acquisition, Terravest focuses on increasing profits by driving revenues through price increases and reducing costs, resulting in an effective post-acquisition multiple decrease from 5.5x to 4.1x. Terravest has generated a 21% average annual ROIC since 2013 and an EBITDA growth of 28% annually over the same period. Terravest operates a scalable, decentralized business model with centralized capital allocation and empowered operating company managers.

An example of improved unit economics is as follows. On a 60k gallon tank, Terravest improves gross margins from 20% to 34%. Terravest has a significant advantage with steel costs; it can buy in enough volume to directly source steel from mills, saving up to 15% on the price of steel, which constitutes 55% of the cost of goods sold. Terravest also has the working capital to buy steel in bulk and stock it in inventory, a financial capability smaller companies lack. As a result, Terravest can build customer orders in 10-14 weeks compared to 20-26 weeks for smaller companies, allowing it to charge a 5-10% premium. Finally, it saves 5-10% on labor costs.

There is some risk to cyclical, given exposure to energy markets. Additionally, there is a perception that the propane markets are in terminal decline, being the target of environmental regulators. However, much of the propane is used for residential and commercial heating in rural areas with no good gas pipeline infrastructure. Therefore, Terravest's delivery tanks are "critical infrastructure." According to the EIA, propane consumption in the US has been stable for 20 years. With boilers in the HVAC business, Terravest mainly operates older style standard efficiency cast iron boilers, which are at risk of being regulated out of existence by continually updated environmental regulations. While true, this again is a slow decline. Demand for boilers is driven by new construction, where the patchwork of differing state and city regulations will likely take time to seriously dent revenues and replacement cycles, where the incremental cost to a homeowner to upgrade existing piping to accommodate a newer style boiler increases switching costs.

In the meantime, the company can continue deploying its cash flow at high rates into attractive adjacent end markets such as biogas, LNG hydrogen markets, and chemical tanks, many of which have a significant overlap in equipment as its petroleum markets. Terravest has a long runway for growth from a large pool of potential acquisitions and a strong operator/capital allocator team with a CIO with a strong track record and a CEO who is only in his early 40s. Finally, management is highly aligned, owns approximately 25% of the company, takes reasonable compensation, and is set to make themselves generational wealth if they continue to compound the business (as they have for the last decade).

Terravest is a smaller, less well-known company with a minimal investor relations presence. The price recently ran up as several value investors published well-thought-out writeups online. I initiated a starter position, intending to invest more in the future.

Samer Hakoura
Alphyn Capital Management, LLC
July 2024

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