



April 25, 2024

## Recurve Capital Partners LP – Q1 2024 Letter to Investors

Q1 was a solid quarter for the partnership with gross returns nearly +19% and net returns +13%<sup>1</sup>. Since the end of 2022 through March 31<sup>st</sup>, 2024, Recurve's gross performance was roughly +100% while carrying 99% gross exposure. There were no new positions or exits in the quarter, although our portfolio weights did change moderately. There have been no significant changes to our portfolio since the October/November period, when we exited two positions and concentrated more exposure into our best ideas.

Most of our companies are performing well, having evolved through the post-Covid era into highly efficient and scalable organizations and primed to continue gobbling up market share from less efficient and weaker competitors. I expect the bulk of our gains to be generated by medium- and long-term share-winning revenue growth converting efficiently to even higher rates of growth in earnings and free cash flow per share.

We seek to buy these category-leading Builder Companies at a single-digit multiple of medium-term normalized FCF/share and we hope to own them for as long as they keep winning and as long as their valuations do not become completely detached from reality...or until we find superior uses for that capital.

The macro economy is working through the tension of tighter credit conditions, still held up by higher inflation, and a relatively healthy demand environment, with consumer trends outperforming expectations (and especially the doomsday predictors) for 2023 and into 2024. Recurve's portfolio primarily is an expression of our best investments based on our company-specific analysis of competitive advantages that should translate into significant future equity value creation – not of any high-conviction macro views. Our companies should beat their competitors in every environment, although of course certain backdrops are more favorable than others for performance. I am excited to partner with our companies as they compete and win share over the coming years.

Typically, I prefer to provide process- and thematic-oriented discussions in quarterly letters that help readers understand how the sausage is made day-to-day. For more stock-specific commentary, I recommend reading our [Insights](#) page and our [Letters](#) page on the Recurve Capital web site<sup>2</sup>, and/or to reach out and schedule a call to have a more detailed discussion.

In this letter, I'd like to discuss two main topics: (1) how we decide when to let winners run and when to trim them, and (2) a brief update on Cogent. I decided to add some company-specific commentary on Cogent because there are some timely developments are interesting and worthy of some discussion. With that, let's dive in.

### When to Let Winners Run and When to Trim Them

Followers of Recurve know that we have owned Carvana through the depths of 2022 and also through its 25x rise thereafter. Carvana was a major contributor to our 2022 losses and has been the single largest contributor to the rebound in performance in 2023 and in Q1 2024. But when a position rises from 1.4% to 25%, it is natural to ask if we should take some chips off the table.

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<sup>1</sup> Net returns are calculated for Class A investors as of January 1, 2024

<sup>2</sup> [www.recurvecap.com/letters](http://www.recurvecap.com/letters). Log in using the password "Recurve369!"

One way to communicate our framework around these decisions is to compare and contrast what we've done with our Carvana position and our position in Armstrong World Industries (AWI). I'll describe what we've done with these positions to show when I prefer to let a winner run (Carvana), and when I think it is sensible to trim one (Armstrong). In short, the decision is based on how much market share growth remains available and how my view of much medium-term valuation has changed.

### **Carvana – Letting it Run**

Carvana is the market-leading, pure-play e-commerce used auto retailer, but it only commands 1% market share in a large and stable used car market. We think it has significant future growth ahead.

Our position in Carvana became material in May 2022, at which time I wrote and shared an investment memo on it. The stock continued to fall throughout 2022, ending the year very near its lows, as it suffered from significant changes across the business. In particular, it was negatively affected by:

1. Higher financial leverage and higher cost of debt capital, particularly when financing its acquisition of ADESA.
2. Lower customer demand due to rapidly rising rates and significant used car price inflation.
3. Lower unit economics from the combination of (1) and especially (2) above, leaving the company overbuilt on infrastructure with a suboptimal level of inventory, all of which created significant negative operating leverage.
4. Materially lower (and negative) earnings and free cash flow.

Stocks don't often drop -99% and recover to become stable, growing businesses. I can think of only a handful of cases, such as American Tower and SiriusXM. It's possible for a good business to fall -99% when it has high operating leverage and high financial leverage and it is hit by a double-whammy of a demand slowdown and credit tightening at the wrong time in its growth phase.

I held onto our shares in Carvana (and bought more) because I believed the double-whammy clearly hurt the business in the short-term, but it did not permanently impair its ability to operate and exploit its superior business model in its end market – and because I believed the company had sufficient liquidity to adjust its operations as needed to get through the downturn. In fact, I believe the company's improved operating discipline, catalyzed by the environment which caused the drawdown, has increased its earnings power at every level of unit volumes compared to my prior expectations. Despite increasing our ownership of the company significantly, Carvana ended 2022 as a 1.4% position due to its dramatic decline.

Throughout 2023, Carvana righted the ship operationally. It showed massive improvements in unit economics, profitability, and operating efficiency while intentionally keeping unit volumes relatively stable. Doing so enabled it to deploy more efficient and scalable infrastructure and processes which will allow the company to scale faster and more efficiently than before. In Q1, third-party data suggest that Carvana grew its volumes roughly 15% y/y and about 20% q/q, despite not yet pursuing many growth-oriented efforts, which would be observable in inventory levels, which ended Q1 very tight. The company is on the cusp of resuming its long-term growth story.

Carvana has a long runway to gain market share in the auto market by delivering faster/better/cheaper used auto transactions to consumers. It has under-utilized fixed infrastructure that it can leverage and grow into with the addition of more labor over the coming years. It can further expand its production footprint to over 3 million units per year. Even then, those 3 million units would represent only about 7.5% market share in the used auto market (although closer to a 15-20% share of its target market). Carvana has significant embedded advantages across multiple dimensions because of its large-scale vertical production and logistics infrastructure, allowing it to differentiate at scale on

quality, convenience, selection, and value to buyers and sellers of cars. Its advantages grow with scale. I expect it to be the most efficient and the most profitable auto retailer in the US.

It's not hard to pencil out some eye-popping valuation scenarios for Carvana. 3 million retail sales units x \$2,500 EBITDA per unit = \$7.5 billion of EBITDA, plus additional contribution from its wholesale businesses which, at that scale, likely would contribute another \$1 billion or more of EBITDA. The free cash flow conversion on a business of that size would be tremendous, especially because of the commensurate transformation to its balance sheet over the ensuing years. Most likely, Carvana would continue to grow because scale begets more scale – especially when the consumer value proposition of faster/better/cheaper improves as Carvana builds more capacity and capabilities. At large scale, Carvana could have one of the most differentiated customer experiences among all e-commerce companies.

I have let Carvana run in the portfolio, despite its large size, because I believe the company has earnings power over \$10/share medium-term and over \$30 longer-term on the current asset footprint. Even at \$75 per share, it trades at a single-digit multiple of my medium-term expectations. It has reasonable line-of-sight (i.e. it does not need significant new, unknown capex) to become a \$100-150 billion company, with potential to continue scaling significantly from there.

Having such an optimistic outlook on the company doesn't mean I won't ever trim our position in Carvana. As our largest position, I am constantly testing its attractiveness on a relative basis versus other existing positions and new ideas on my watchlist. If the stock were to continue putting up incredible short-term performance, it could materially change my view of the risk-adjusted return potential compared to other investment opportunities.

### **Armstrong World Industries – Trimmed**

I trimmed AWI in early 2024 after it enjoyed an incredible burst of performance, +80%, from October 2023 (pre Q3 2023 earnings) to February 2024 (post Q4 2023 earnings). For a business that grew revenue +5% and EPS +15% in 2023, this was exceptionally strong short-term performance for the stock driven by multiple expansion.

In October, AWI was trading at a low-teens multiple of near-term earnings and had a steady earnings growth algorithm comprised of (a) price increases above inflation, (b) modest volume growth, and (c) steady margin expansion. I highlighted the quality of the business and AWI's great long-term prospects in a [late-2023 Insight](#).

AWI is a fantastic business and the company already possesses dominant market share in the ceilings market while enjoying a stable duopoly-like market structure. This structure likely supports a better risk-adjusted outcome than one in which AWI is more disruptive in its market. It has ambitions to grow moderately faster than its market through product innovation and by continuing to expand into the specialty ceilings and walls businesses. However, as the dominant, non-disruptive player in a market that is not very dynamic, it is unlikely that AWI can move the needle enough on self-help growth initiatives to generate material and persistent outsized growth. That doesn't mean AWI doesn't have an attractive medium- and long-term earnings growth outlook, but it makes me more open to trimming our position if its valuation expands significantly in a short period of time.

AWI traded at a low-teens multiple of the company's 2024 earnings as recently as late October, but now trades at around 20x. It isn't an unjustifiably expensive valuation by any means since it is such a high-quality business, but it is closer to fair value than before. With the valuation at these levels, I expect AWI's stock performance will correlate much closer to the company's CAGR of free cash flow per share than it has over the past year. If and when AWI comes back into our buy zone, I will be happy to revisit our position sizing.

Part of our reason for trimming our position in AWI when we did was because I saw a superior use for that capital: to increase our exposure to the cruise lines after they started the year poorly. It would have been a more difficult decision if there hadn't been an acute and compelling case to rebalance the portfolio. We were fortunate that the cruise lines were hitting their YTD lows while AWI was hitting its post-earnings highs, opening a >40% performance gap between them. Our cruise companies have cheaper valuations and higher EPS CAGRs than AWI, so I saw this as a compelling opportunity to rebalance exposure. So far, the change has been nicely accretive – our cruise companies have recovered >20% of performance while AWI has traded down slightly from our selling prices.

## Conclusion

I hope these live case studies help illustrate how we think through the “let it run” vs. “trim” decision trees. If a company has more open-ended growth such that it may still trade at a single-digit multiple of medium-term EPS or free cash flow per share after a burst of performance, we will be more likely to hold on and let the business continue compounding in our portfolio. If it appreciates rapidly enough to move its valuation outside of our medium-term “buy zone” range, we *may* consider trimming the position and rebalancing the portfolio (or allocating to new ideas). There are no hard rules and there are many judgments that must be made, but hopefully this section helps explain the way these decisions are assessed.

## Update on Cogent Communications

I'd like to give a brief update on Cogent because of some very recent and fascinating developments over the prior week. There are a lot of moving parts, many of which I've written about previously. For more thorough background, I'd recommend reading our three recent Insights on Cogent:

1. [The Wavelength Opportunity](#)
2. [Hidden Value](#)
3. [Hidden Value Part 2 – Cogent's IPv4 Portfolio](#)

To summarize our thesis on Cogent briefly, the company's acquisition of Sprint Wireline was transformational to Cogent's long-term value which created an opportunity for a high reward/low risk investment that was among the most compelling skews I've ever encountered. The key points are described below:

1. By repurposing the Sprint fiber network, Cogent can address a whole new end market (Wavelengths) which could become Cogent's largest and most profitable business.
2. The transaction also contributed significant valuable assets which: IPv4 addresses (worth \$1.5-2 billion by my estimates), data centers (>\$1 billion), dark fiber (>\$1 billion), and cash from T-Mobile (\$700 million).

Our upside case depends on Cogent's efforts in Wavelengths to be reasonably successful, but we can make nice returns even if they are only moderately successful. Our downside case is protected by the robust portfolio of monetizable assets mentioned in the second point above. When we include the value of Cogent's core business, the breakup value of Cogent is significantly greater than the company's enterprise value. However, this is not a sum-of-the-parts thesis. We expect to generate performance from Cogent's future growth and free cash flow generation – not the value of its monetizable assets. When we assess the value of the growth we expect Cogent to generate, it is not hard to pencil out upside scenarios with equity value exceeding \$10 billion (>\$200 per share).

Now, onto the recent developments.

On Cogent's Q4 2023 earnings call, Dave Schaeffer discussed the company's options for creating value from its IPv4 address portfolio: (a) selling some or all of them, (b) continuing to lease them (and raising prices), and/or (c) securitizing lease revenues.

With a market value around \$50 per address for its large address blocks, Cogent's ~38 million addresses are worth between \$1.5-2 billion. Alternatively, it can monetize these assets through securitizations in the ABS market. As of the writing of this letter, the company has just priced its first securitization, raising \$206 million of capital in the first-ever IPv4 lease securitization transaction in the market.

The securitization is backed by the company's IP leasing business which currently consists of about 12 million leased addresses and generates ~\$40 million of run-rate revenue which carries 95% margins. My favorite line from the company's roadshow materials was: "The greatest cost is the cost of sending the customers their bills."

While we have limited historical disclosures, Schaeffer suggests that the business is growing >3% month-over-month and >40% y/y, and has only 0.8% *annual* churn. It is a very high-quality revenue stream, especially considering that Cogent's lease prices are about 30-50% below current wholesale market levels and are >90% below the prices AWS and Azure charge customers to lease their IPv4 addresses (Cogent charges \$3.60/year vs. Amazon at ~\$44 per year). Interestingly, Cogent's IPv4 leasing customers can bring those IP addresses into their AWS environments, providing an attractive arbitrage opportunity that can save cloud computing customers significant money. Recognizing its pricing was too low, Cogent raised prices for new customers by 50% as of March 1<sup>st</sup> and has seen no impact to its leasing momentum. The combination of healthy new volume growth, higher new lease pricing, and a gradual repricing of the existing customer base should drive significant growth in leasing revenues over the coming years.

While it is of course tempting for Cogent to monetize a \$2 billion IPv4 portfolio that was, until recently, marked at zero on its balance sheet, the path to optimizing long-term value is not immediately obvious to me. If leases are extremely sticky and have long-term pricing upside, Cogent could use its address portfolio to generate >\$200m of leasing revenue over the next few years, or over \$4/share of pre-tax FCF, up from <\$1 today. Longer term, leasing prices and revenues could rise further and generate pre-tax FCF/share in the \$5-10 range. Selling them would generate \$40 of one-time pre-tax gains.

My preference is for the company to monetize a portion of its unleased addresses to "hedge" against the long-term risk of IPv6 migrations (see our [IPv4 Insight](#) for more details), while simultaneously maximizing revenue in the leasing market. Recently, the company enhanced sales incentives and, as mentioned above, increased pricing to accelerate leasing revenue growth, and it should pursue an aggressive growth strategy in this market until it feels demand saturation. Once leasing demand slows, the company can fine-tune its sell-or-lease strategy to maximize value. Thankfully, we are partnered with Dave Schaeffer, a hyper-rational capital allocator who is keenly aware of all the market's dynamics and who has a long track record of creating significant value for Cogent's shareholders.

Cogent's new IPv4 securitization opens new avenues for the company to raise capital opportunistically which it can use for accretive and strategic capital allocation. For instance, about half of the capital raised in its 2024-1 ABS deal will be used for an early buyout of a terrible wholesale lease Sprint Wireline had from Verizon. This uneconomic lease had roughly -\$150 million of economic value when the Sprint acquisition closed and Cogent is able to buy it out at a 12% discount rate and save nearly \$50 million of capex per year for the next 3 years. Future IPv4 lease securitizations could be used for other accretive actions, such as accelerating capital returns for Cogent's shareholders via buybacks and/or dividends, or highly accretive M&A.

### Closing

Hopefully this letter deepened your understanding of Recurve's processes and decision-making frameworks, as well as some important developments in Cogent, our #2 position in the portfolio.

The market continues to wrestle with healthier economic growth offset by stickier inflation, the combination of which keeps much of the market focused on the Fed's actions and the rate environment, and which has caused significant market-wide swings in the market in recent months. Volatility may come our way for good or for bad, but my approach will be steady all the way through.

Many market participants are eager for an easing cycle, but I continue to believe that having a reasonable, non-zero cost of capital is a good thing for *good* businesses which will help them build greater advantages and reduce speculative, money-losing and disruptive competitive behavior from *bad* businesses. While our portfolio is sensitive to significant changes in the rate environment in the short-term, I neither explicitly hope for rate cuts, nor do I believe we need them to generate attractive medium-term and long-term returns for the partnership given the strength of our companies' business models and their competitive advantages.

As always, I'd like to express my deep gratitude for your interest, partnership and support.

A handwritten signature in black ink, appearing to read 'A. Chan', with a long horizontal flourish extending to the right.

Aaron Chan, Founder & Managing Partner

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