Luxembourg, 6th of Mai 2019

Dear Limited Partners,

As usual, I start with a brief presentation of the performance, followed by an analysis of the general market situation and end with an analysis of one of our positions.

I. Performance Analyses

The performance of the fund was 1.3% during the first three months of 2019.

The three best performers were:

- Coty Long: 1.90 %
- Dollar Tree: 0.43%
- Brighthouse Financial Long: 0.39 %

The three worst performers were:

- Carvana Short: -3.90 %
- Sixt Short: -0.68%
- Credit Acceptance Corporation: -0.45%

This is a significant underperformance of the fund, compared to the main indexes that performed between 10% and 14% during Q1.

Given that we are a long-short equity fund, we can decide our long and short exposure to the market and in what assets we invest in. During Q1, the fund was on average 10% net short. To have such a reduced risk exposure was a suboptimal decision, I underestimated the rebound of the beginning of the year.

Thus, the performance was reasonable given that we managed to generate a small profit despite our overall very risk-averse exposure in a market that performed very weak.

II. General Market Situation at the end of last year?

In the following chart, you can see that the S&P500 lost over 10% during the last quarter of 2018, before the high rebound we experienced at the beginning of 2019. What happened? Why did investors change their minds so fast? What made them see the future so less bright in 2018? We all know there was no major natural catastrophe or significant political instability that occured.

Market Participants exchanged billions of shares at widely different prices. The price of large known companies varied by more than 20% within a short period. In the following chart, you can see the price evolution of the stock of United Technologies. They are one of the last American industrial conglomerates, owning brands such as Otis, Carrier, Pratt & Whitney and Collins Aerospace.

How can the valuation of a such large, diversified company change from one moment to another without any company related news? The most prevelant factor was the oral intervention by Mr. Powell, Chairman of the Federal Reserve Bank (FED). After another speech from Mr. Powell, the market surged at the beginning of 2019. I am aware that economic phenomenas cannot be explained by one factor. However, by considering the extreme reactions to the speeches, during the past month, we can at least underline how “central bankelized” the market has become.

Low interest, combined with the purchase of assets by the Central Banks (quantify easing, assets defer between Central Banks), are and were the main factor of fast inflation of financial assets and real estate over the last ten years. Any modification to this main factor can have significant effects on prices.

Indeed, higher interest rates make borrowing for companies and private persons more expensive and saving more attractive. This leads to a decrease in consumption, investment and an increase in savings. Furthermore, the higher the risk-free interest is, the more yield investors demand to hold risky assets. If interest increases from the current US rate of 2.4 % to the 2007 rate of 5%, the income of assets must increase by 100% (just as interest did) or the asset price has to decrease by 50%. Of course, the revenue of assets (dividend, rental income) can grow into the higher interest environment through inflation and economic growth. The probability that this does not happen is this time higher than during previous cycles. First, the relative attractiveness of the risk-free rate is calculated in relative terms and not absolute ones. Second, the probability is higher that we are at the end of the current cycle because of the length of it. Of course, this is only the case if we believe in cycles. In Europe, the risk is even higher because of the still lower interest.

Central Banks want to raise interest rates to be able to use this well known monetary tool to fight the next recession. The Federal Reserve Bank managed to increase the interest rate during this cycle from 0% to the current 2.4%. However, the European Central Bank did not start raising interest rates. During this very long economic expansion, interest rates have been close to 0% for an unusually long period and they are still not back to levels before past recessions.

As you can see in the following chart, the Federal Reserve Bank decreased the interest rate from 6.5% to 1% during the 2001 recession. They only managed to get up to 5% in 2007 before a collapsing housing market forced it to decrease the interest again.

The reaction of financial markets during the last quarter of 2018 changed the forecasted interest rate increase by the Federal Reserve Bank. Several public intellectuals, business people and money managers have predicted this problematic. In 2010, they wrote a letter published by the Wall Street Journal that calls for the Federal Reserve Bank to stop Quantify Easing immediately (published by the Wall Street Journal on November 15th, 2010). The authors forecasted the complicated future task of Central Banks to normalize monetary policy, as to say, to increase the interest rate and stop quantify easing.

What happened in December is what was described in this letter as "*worry that another round of asset purchases, with interest rates still near zero over a year into the recovery, will distort financial markets and greatly complicate future Fed efforts to normalise monetary policy*".

However, even if Central Banks lack the full effects of the critical tool of lowering interest during the next recession, I believe that there is still a panoply of monetary instruments. Of course, most of them are non-tested, given that the Central Bank of Japan is probably the only one that experienced these long-term low-interest rates. I think, especially for Europe, an essential tool to fight future recessions is not a monetary one, but fiscal and an increase of Central Europe government demand. Maybe if the next time we stand on the brink of a European breakup, we will manage (again) to come to our senses, cooperate more on tax cuts and increase of the demand from the government.

A much worse scenario is non-controlled inflation of consumption goods and wages that force Central Banks to increase interest fast despite the before mentioned problematic. Fast, decreasing value of money has been known for a long time. Lords tended to dilute their silver or bronze hard currencies with less expensive commodities to finance wars. Since the abolishment of the Bretton Woods system that linked the US Dollar and Gold, the Federal Reserve Bank does not even need to dilute Gold. It can print new money without any restrictions. Very fast devaluation of a currency (or rapid increase of consumption goods) can lead to political instability, as Germany experienced after the end of the first World War, and to a currency reform.

Regarding our investment strategy, I believe that markets are protected against an extreme downside (over 20%) as long as we stay in a low inflation scenario where Central Banks can intervene orally and materially.

On the other hand, I believe that Central Banks will use any sustainable market relief. If the economy continues to grow at least at the present rates it will increase interest and taper quantify easing. This can considerably limit the upside potential of markets during the next years.

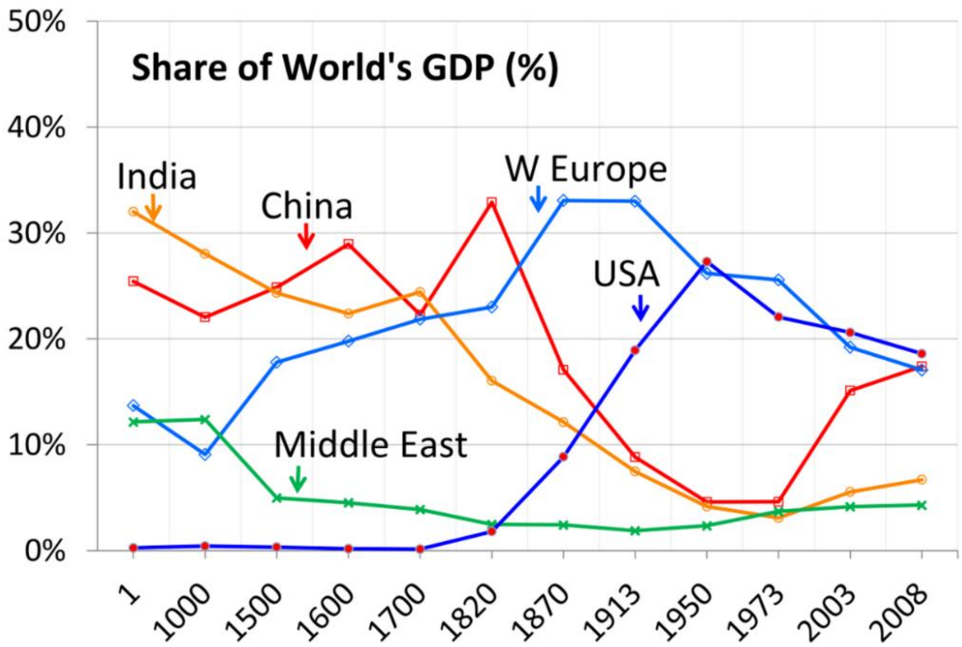
III. US-China Trade negotiations

During the last days, the public perception of trade talks between the US and China has considerably increased. This is mainly because of the decision by President Trump to raise tariffs on particular goods (worth around $200 Billion) from 10% to 25%. In my opinion, as described in previous letters, the probability of an overall agreement is very low at least in the short and mid-term.

What we are referring to as “trade talks” are much more than just trade talks. The requests by the United States government have substantial implications on China’s political, economic and strategic position. I do not doubt one second that the two governments could easily compromise on the import tariffs on cars.

When Nixon first travelled to China in 1972, he had in mind that an opening of the Chinese Markets could mean cheap labour and future demand for US goods. For the Chinese government, the opening of their market was primary a goal to benefit from the knowledge of the advanced western societies, at least in economic terms.

By taking many more reasonable steps over the last forty years, the Chinese Government managed to grow its economy ten times faster than the US and Europe. China’s economy is now more of less producing the same output.



This economic renaissance, combined with the increasing claim to power especially in Asia, causes more and more discomfort among western politicians. I believe that this symbiosis cannot further exist. The United States wants China to apply Western Free Market rules among other subsidies, state control, Intellectual Property Protection, as well as reduce its military influence in Asia.

China’s fast development was based on not applying those rules. The belief of the West that Free Market societies are superior and that the Chinese government is further or later forced to apply to those rules seems, at least until now, naïve. Unitil now, the gamble of accepting China in the World Trade Organisation is not working.

Without going in too much into detail, I believe that many factors of the Chinese Economic Model are superior to the Western. I doubt that the growth that the country experienced over the last fourteen years would have been possible with a Western Democratic Free Market Model. I further believe that the power of the Chinese Government is more fragile than our democracies in the case of a sharp economic downturn. The Chinese population lacks several standard civil rights. How will they react if their financial situation does not improve in the short term or even deteriorates?

IV. Carvana

Carvana (CVNA) is an internet platform for buying used cars. It trades on public markets since 2017. The company has a non-transparent structure. Mr. Garcia Junior, the main shareholder and CEO, owns 97% of the voting rights through B shares, giving common class A shareholders no voting rights. Furthermore, the listed company is not an operating company, but a holding company that currently owns only a minority interest in the operating company. Finally DriveTime, Mr. Garcia's father business, is a client and major supplier of Carvana.

Carmax (KMX), the largest used vehicle retailer in the US, forecasted 2019 revenue numbers 5.5 times higher than CVNA. However, KMX, a profitable company, only has a 20% higher market capitalization. I think, in this case, market capitalization is a better tool than enterprise value to compare the value of both companies. The main assets on the balance sheet of KMX are financial auto loan receivables and inventory. CVNA will need the same kind and amount of assets to generate similar revenues.

Two questions arise.

First, Is KMX undervalued? I assume that KMX is trading around its fair market value given that the company:

- Operates in a low gross margin business (under 13%)
- Operates in a very conjectural sector
- May get more and more pressure from car manufacturers (prices of new cars) that sell fewer vehicles due to the buying behavior of a new generation and the appearance of new technologies (electric vehicles)
- Has a highly leveraged balance because of the need for a high inventory of a volatile asset
- May have to sell more and more cars over the internet and deliver them home the next day (because of CVNA)
- Generates a revenue growth of around 6% a year

Secondly, can CVNA be considered as a technology company as most investors in the company do? Or is it just another used car sales company?

Tech companies are well-known for having very low tangible assets. The few assets they have can be highly leveraged. Amazon (AMZN) disrupted the book market, by selling books online. They saved on sales points and centralized inventory in less expensive neighbourhoods. By centralizing inventory, they can diversify and optimize their inventory. I even think that AMZN's success derives more from the cloud revolution (AWS), which can be seen as a black swan event for Mr Bezos, than from selling goods over the internet. Of course, selling products over the internet is a necessary condition of the AWS's success because members of its marketplace are direct clients of AWS.

Cars, especially low valued used cars, are a less exciting good to sell over the internet. This might be a reason why nobody has successfully done it after more than twenty years since the invention of the internet. The logistics of a book or new bed are very different to the logistics of a car. Cars are heavy, and Gross Profits on used cars under $20,000 are meager. It is true that CVNA and KMX generate a high percentage of their gross margin from services (for example) and selling receivables. However, those revenues are always limited to the cars they sold, and the overall Gross Margin is still only just over 10%.

Furthermore, most markets present the same vehicles in regards to model, year, odometer and colour. This takes the exclusivity of a $20,000 car that might be worth transporting halfway across the country and still be able to sell it with a profit. In an extreme case, a Florida based client can consider buying a book from AMZN that is delivered from an inventory in Chicago, but this will be more difficult for a car.

Finally, cars have to be reconditioned before they are sold. This means that the company needs to hire more people and invest in more assets than a purely internet-based company would have to do. Indeed, you do not only need to increase the number of inventory places to increase the number of markets where you can sell cars at a competitive price, but you also need to hire employees at those places for reconditioning. This makes the internet-based model of selling used vehicles very similar to a traditional used car retailer.

Can CVNA justify its significant losses by the Silicon Valley doctrine of "Blitzscaling" in a winner takes it all market? In other words, is CVNA getting more value from any new customer as is the case for Facebook or Amazon? In many tech areas, the winner takes the main part of the cake. Fast growth is essential because every new customer increases the value of the company and gets locked in, meaning that the company always has an advantage compared to the competition. However, often the management of massive loss generating companies abuses "Blitzscaling" to justify their losses.

People don't buy cars as much as they buy books or even any kind of furniture. Cars are also much more expensive. CVNA's average used car price is around $18,000. Clients of CVNA are average or below average earners who have a high sensitivity to price. Before they buy a new car, they will probably compare prices with competitors offering similar cars and might even shop somewhere else if they can save a couple hundred dollars. There is no real "lock-in" effect as there is for Amazon. There is also no "the first gets it all" effect like for Facebook.

Finally, I do not believe that CVNA has a technological advantage that provides a higher gross margin like KMX generates. I consider that the difference between buying and selling price is limited and that neither technology nor size can change that. There is a high horizontal and vertical competition in the highly fragmented used car market. By horizontal, I mean competition between companies like KMX, CVNA, AutoNation and the thousands of independent Car dealers. By vertical I mean the competition of selling its cars privately, as to say executing some tasks of the sale process personally. Indeed, there are many internet sites where you can sell a car. Many also offer direct funding, inspection and reconditioning with warranty. The advantage of those companies is that they do not take the risk of owning the asset, so they need less gross margin. Those companies are considered as pure internet players.

Let us assume that a person who buys a car of $18,000 makes, on average, $40,000 per year, which is around $2,900 net per month. $720 (5%) saved on a car of $18,000, equals the salary of five working days. This same reasoning can be applied to the supplier side, as to say private people selling their cars to CVNA. Indeed, cars bought from private clients offer a much higher margin for CVNA than those purchased at the auction where competition is high and direct. So what is as vital as knowing if people tend to buy more cars over the internet is to see if they are keen to sell more cars off the internet.

I conclude that CVNA is operating a business model that is not different from the oldfashioned business model of KMX. Therefore, we can compare the valuation of both companies directly. The most bullish analyst for CVNA (Wolfe Research) forecasts revenues of $12 billion in 2022.
To get to those 2022 numbers, I considered growth numbers of (70%;50%;35%) for the years (2020;2021;2022). As you notice, I considered the forecasted 6% growth for KMX.

	CVNA			KMX		
	CVNA revenues	600%	Cvna	KMX revenues	KMX growth	
Years		**Growth**				
2019	**$ 3,500.00**			**$ 19,000.00**		
2020	$ 5,950.00	70%	100	$ 20,140.00	6%	600
2021	$ 8,925.00	50%	170	$ 21,348.40	6%	636
2022	$ 12,048.75	35%	255	$ 22,629.30	6%	674.16
2023	$ 16,265.81	35%	344.25	$ 23,987.06	6%	714.6096
2024	$ 21,958.85	35%	464.7375	$ 25,426.29	6%	757.4862
2025	**$ 26,350.62**	**20%**	**627.395625**	**$ 26,951.86**	**6%**	**802.9353**
2026	$ 30,303.21	15%	752.87475	$ 28,568.97	6%	851.1115
2027	$ 33,333.53	10%	865.8059625	$ 30,283.11	6%	902.1782
2028	$ 36,666.88	10%	952.3865588	$ 32,100.10	6%	956.3088
2029	$ 40,333.57	10%	1047.625215	$ 34,026.11	6%	1013.687

It takes CVNA another seven years to equal KMX's revenue numbers in a best-case scenario. During those seven years, the company will generate more losses and face many more risks than KMX does. Given that CVNA is a non-transparent company operating in a conjectural low margin environment and that the stock is highly valued, I believe that the company offers a mediocre risk-return opportunity.

I hope you enjoyed reading.

Kind Regards,

Marc Daubenfeld