JDP
CAPITAL MANAGEMENT
2023
ANNUAL
PARTNERSHIP
LETTER

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CAPITAL MANAGEMENT

Survivor & Thriver Fund, LP

2023 Annual Partnership Letter
(edited for SEC compliance, 2024)

Dear Partner,

Two thousand and twenty-three was a great year for the market and our fund. For the full year, the Survivor & Thriver Fund was up 36.5% net to investors compared to a gain of 26.2% for the S&P 500 including dividends.

Last year served as a reminder of how important it is to stay invested, especially when market noise seems to overwhelm the fundamental reasons to hold.

Throughout much of 2023, the market was dominated by narratives such as expectations of persistently higher interest rates, an impending earnings recession, and worst-case geopolitical outcomes. If that wasn't enough, the soundbite "US stocks are overvalued" echoed constantly in financial media, akin to a pet parakeet in the background.

As 2023 progressed, $240 billion was withdrawn from US equities, and US money market fund assets reached $5.76 trillion in late November.[1] For context, during the initial shock of the Great Financial Crisis, money market fund assets peaked at **$5.8 trillion** in December 2008 and averaged below $3 trillion from 2010 to 2019.

For long-term investors, the most detrimental trend in 2023 was the act of selling stocks to buy short-term treasuries merely to exit the market.

Although this trade might have been justified for some, the "T-Bill and Chill" movement was motivated by the idea that one could wait out the anticipated market turmoil with a guaranteed positive return and then re-enter the stock market after it bottomed.

As the year progressed, markets overlooked improving earnings, aided by cost-cutting, productivity gains, and debt reduction. The broader US market also became attractively priced, trading at a low double-digit multiple of next twelve months (NTM) operating earnings (excluding FAANG stocks).[2]

Meanwhile, inflation was falling rapidly. In November 2022 when the Fed signaled a pivot in rate policy, markets took off in what was the most spectacular fourth quarter period of panic buying.

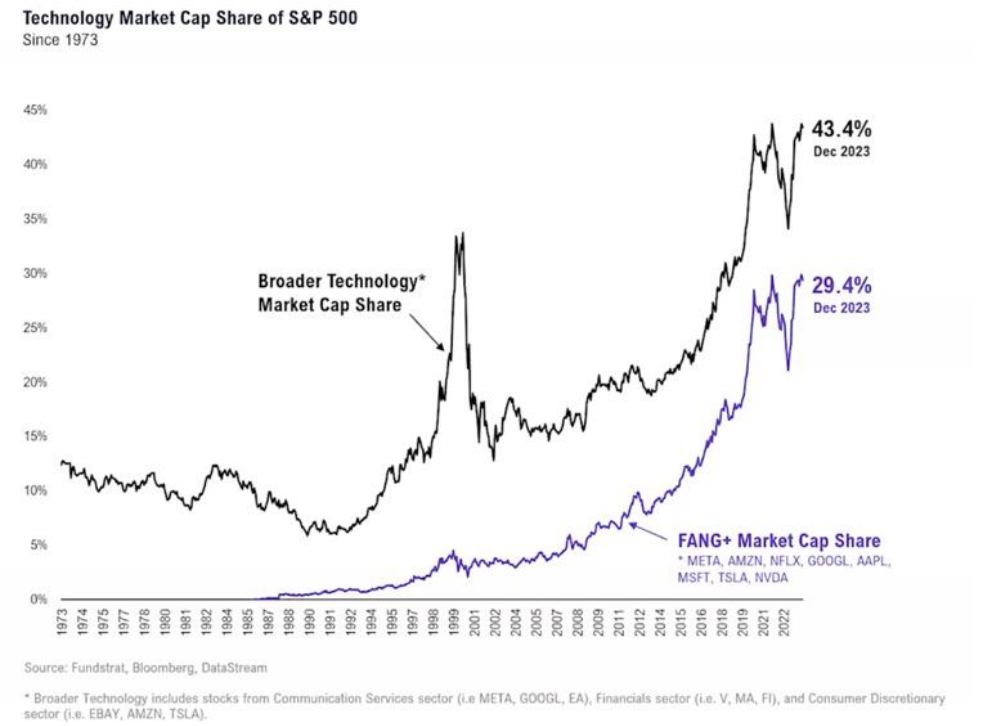
By yearend, the S&P 500 had outperformed the 2-year T-bill 5% yield by nearly 5 times.[3]

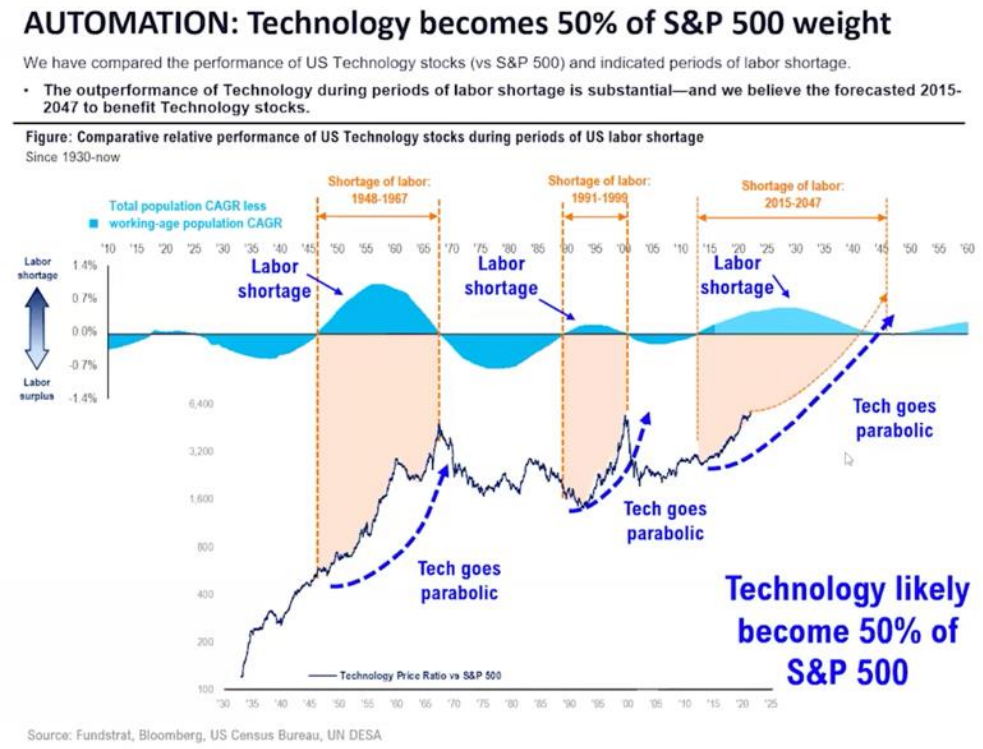
<u>The case for technology to continue taking share of US market capitalization.</u>

I found a recent Fundstrat presentation compelling in its argument for why technology as a sector should make up 50%+ of the S&P 500 (see below slides).

[1] Bank of America, JDP estimates
[2] JDP research, Capital IQ, Bloomberg
[3] Capital IQ

Fundstrat argues that the world is running short of workers able to keep up with demands of the future economy. As the population grows faster than the workforce the only way to meet production needs is through technology spend and automation.



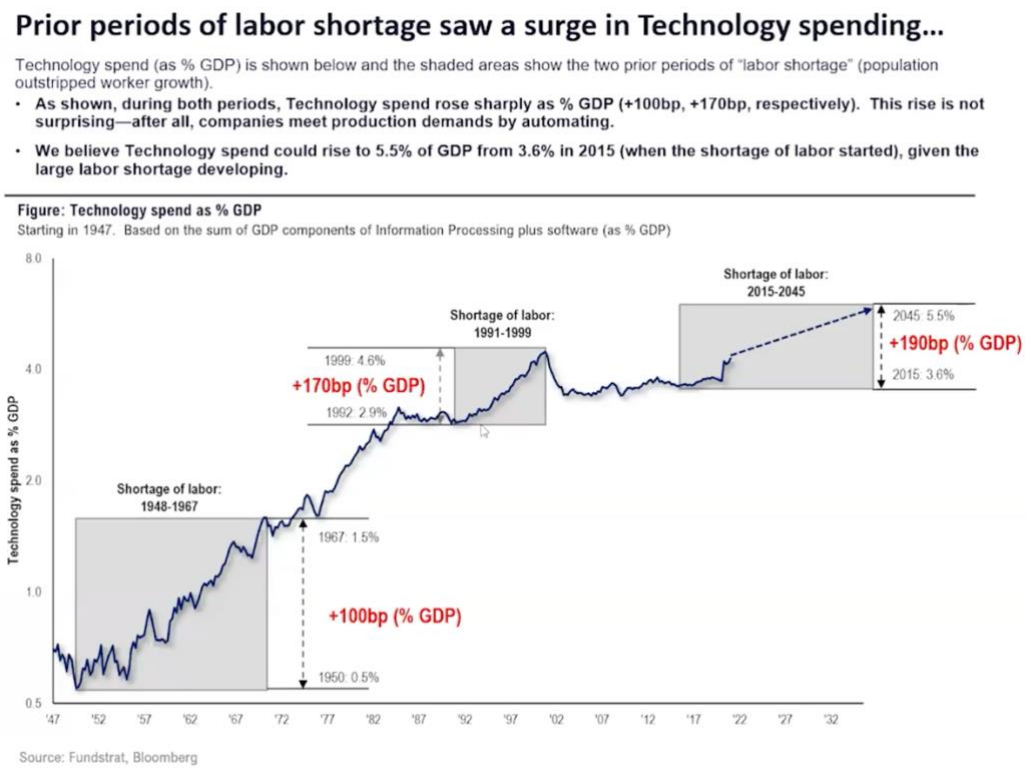


The presentation emphasizes that getting technology right will be increasingly crucial for investors. It predicts that tech spending as a percentage of the US GDP will rise to an estimated 5.5% over the next decade, amounting to roughly $2 trillion of an estimated $40 trillion economy.

I couldn't agree more.

The pace of disruption is accelerating as businesses strive to stay relevant. The adoption of new technology not only transforms existing industries but also gives rise to entirely new verticals, often originating from once-small niches. This evolution contributes to the overall market capitalization. For instance, streaming entertainment, cybersecurity, electric vehicles, mobile payments, and artificial intelligence were niche industries not too long ago but have now surpassed the size of many established 100-year-old industries.[4]

"When companies adopt technology, they do old things in new ways; when companies internalize technology, they find disruptive new things to do" --Mark Zuckerberg



Portfolio Review

Performance in 2023 was driven by our long-time holdings in Spotify, Amazon and Roku which rebounded significantly and outperformed our overall results. This was offset by our special-situation positions that were down materially. Our basket of "*busted SPACs and small cap untouchables*" purchased in late 2022 beat the S&P 500 but was disappointing. Other smaller positions trailed the index.

[4] JDP estimates, research

Most of our *untouchables basket* was sold after prices moved up and longer term potential was not obvious. With the benefit of hindsight, the basket was a mistake. We would have been better off simply doubling down on our core positions after 2022 versus making a market-bet on the most beaten-up names.

Qualcomm was sold after I realized the company's hopeful transition to a less cyclical auto connectivity play will likely have a smaller impact on EPS growth over the next 5-10 years than I had expected.

Proceeds from exited positions were used to upgrade the quality of the portfolio. New positions include Veeva Systems (discussed below) and CyberArk Software. We also added to several toehold positions including a Chinese healthcare services stock with a long history of being at the forefront of innovation.

The fund has 16 total positions with the top four accounting for 50% of assets. Having a dozen smaller positions is more a result of I think is an unusually rich period for stock picking and not a permanent shift away from our historically more concentrated portfolio.

Selected portfolio updates

Spotify

In 2023, Spotify continued to leverage its dominant position in music streaming to expand into adjacent businesses beyond music. The company demonstrated significant progress across key metrics crucial for long-term value creation: user growth, pricing power, increased engagement in a widening spectrum of audio entertainment, and the generation of free cash flow.

Spotify is also beginning to blossom financially. In December, I discussed the **monetization gap between streaming audio and video on the Chit Chat Money podcast** and Spotify's substantial opportunity to unlock the value of the spoken word online (click link to listen).

User growth: Spotify is expected to have added 110 million users in 2023 bringing total users to 600+ million or ~23% YoY growth. At this pace Spotify will have 1 billion users by Q2 2026.[5]

Price hikes: The $1 per month price increase implemented in 2023, the first in a decade, appears to have been well received by the 226 million paid subscribers as of 3Q'23. A significant win, in my opinion, was the undisclosed leverage with labels as mentioned by Daniel Ek during the 3Q call. The market is starting to wake up to the idea that Spotify has more operational and business model leverage than previously believed.

Audio books: In December, the audio book vertical underwent a relaunch, now offered as a benefit for premium subscribers. This marked a significant enhancement from the original plan, which involved selling audio books individually on the platform. Premium subscribers now enjoy 15 hours of monthly listening across a library of 150 million audio books, all included in the $10.99 monthly subscription. For those seeking additional listening hours, supplementary hours can be purchased. The inclusion of audio books as a premium subscriber benefit exemplifies a form of value creation that might not have been feasible when we initially invested in Spotify in early 2019, given the company's size and its evolving ad-tech infrastructure at that time.

[5] JDP estimate

Advertising: Advertising has experienced an annual compound growth rate of 33% since our initial investment in the stock five years ago. By the end of 2023, advertising revenue is anticipated to reach a run-rate of approximately €2 billion, which, considering the platform's 150+ billion hour size, is still relatively modest. However, advertising plays a pivotal role in margin expansion and incremental profitability for Spotify. Growth in advertising is key for margin expansion and incremental profitability. With more scale and new verticals, incremental ad revenue is more profitable with estimated 50%+ gross margins vs ~10% for the early days of a sub-scale freemium music business. Advertising is more valuable today as well because users spend more time on the app and can be followed across a wide variety of podcasts genres, music, and audio books. Spotify generates a ginormous amount of consumer data. The ability to improve personality profiles and the number of inferences with user growth is a leap forward for ad measurement and ROI compared to the past.[6]

Layoffs/ financial inflection: The recent announcement of a 17% layoff should help reveal earning power buried beneath that fat. My guess is that ongoing expenses below gross profit could stabilize at around €3 billion annually sometime in 2024, potentially leaving approximately €1 billion of run-rate EBIT by the end of 2024. The point is not to try and forecast earnings but to highlight the trajectory of profitability moving in the right direction. Considering how bearish analysts have become on Spotify's margin growth, even a small amount of unexpected operating leverage could have an outsized impact on the stock this year.

Roku

In 2023 Roku started to recover from the advertising recession and the lingering COVID-related supply chain issues for its hardware that persisted through 2022. The platform achieved a significant milestone by surpassing 100 billion hours of streamed TV, with active users growing to approximately 80 million (estimated for 4Q).[7] Both of these metrics have nearly doubled since our investment three years ago. Additionally, Roku successfully entered the market with its own line of TVs in 2023, offering high-quality TVs at exceptionally competitive prices. As of 3Q 2023, over 86% of Roku's revenue was derived from advertising.[8]

Roku's dominant position as the TV operating system (OS) leader in North America with nearly 50% share provides valuable advantages for monetizing the tail of ad-supported TV content.[9]

The underlying thesis for Roku is anchored on the idea that *ad-supported TV content* will surpass the market for paid TV content as technology continues to commoditize content. While traditional media companies may need to consolidate in to survive, the largest TV operating systems will continue to see more content added to their platforms.

Under this scenario, the dominant TV operating systems (Roku, Fire, Android) become more valuable as a tool for monetizing older content than what is possible on a media app that does not own the TV operating system.

Owning the OS allows Roku to prioritize its own ad-supported channel - The Roku Channel (TRC) - in both the home screen, and when consumers search for shows. Roku should be able to provide a better user experience for ad-supported TV with lower ad loads and more relevant ads because the OS sees customer behavior across apps. Roku can then offer media owners higher advertising

[6] JDP Research and estimates
[7] SEC filings, Roku investor relations
[8] Roku investor relations
[9] Roku 3Q 2023 earnings report

returns over time compared to a premium content app (say, Netflix or Disney) that might have a free component to the core paid offering but must always prioritize paid/premium content.

TRC continued to grow in 2023 and our estimate is that the channel represents 8% to 10% of total hours streamed on the Roku platform or 8+ billion hours. Roku's profitability runway is misunderstood in our view because TRC is growing with Roku's platform hours *and* as a percentage of the total. Assuming TRC's ad inventory was maximized the channel alone could be worth as much, if not more than Roku's current market cap.

The primary headwind to the stock has been the company's bloated employee base and lack of profitability. The new CFO Dan Jedda drastically cut costs in 2023 and has stated plans to swing back to positive EBITDA in 2024. Roku has $1.8 billion of cash and no debt.

For those interested in listening to an excellent deep dive on Roku I recommend this Business Breakdowns interview with Joe Frankenfield.

Amazon

Amazon has finally started to turn the ship around after overspending during COVID. CEO Andy Jassy has refocused the company around efficient growth within Amazon's primary verticals. earnings and free cash flow surprised the market in 2023 and I believe this trajectory will continue in 2024 as excess capacity gets absorbed and corporate costs stabilize. Although Amazon is a mega-cap stock, we see Amazon continuing to grow operating earnings faster than the S&P 500.

Special situations - Paramount Global & Medifast

Paramount Global and Medifast both dramatically underperformed in 2023. Historically we have used situation positions to generate uncorrelated returns and to offset volatility in our core portfolio. Special situations are essentially deep value bets with a catalyst such as a sale, settlement of a lawsuit, refinancing of debt, an acquisition, etc. For example, we exited our 3-year special situation investment in Indivior PLC for multiples on our money ending in 2022, which was otherwise a horrific period for small cap drug stocks and the market overall. We are not experiencing the same luck currently.

Paramount is a goodCo/badCo where the streaming business, sports rights and Paramount Studios is growing and valuable, while the linear TV business, which is the historical source of profits, is melting like an ice cube. Paramount has too much debt and the stock trades for a deep discount it's the sum of the parts. We were hoping for a sale of the linear assets to pay down debt that had drawn interest from a number of private buyers in 2022. However, based on recent reports, Paramount has met with multiple potential strategic buyers for the entire company. Although a full buyout might command a substantial premium to the stock's current $14 per share, it would not be the ideal scenario for investors like us that wanted either hold on to the direct-to-consumer streaming business and Paramount Pictures or sell them separately after profitability is stabilized. An outright sale of Paramount would likely undervalue the good parts of the business in order to offset the declining pieces. For now, we will hold on and reassess as things develop.

Medifast has essentially nose-dived since we bought the stock last year. Unlike Paramount, Medifast has no debt, software-like gross margins, high returns on capital, and an unusually flexible cost structure. Medifast is the largest non-drug weight loss business in the US, is conservatively managed, and has a very long track record of returning the bulk of profits to shareholders in dividends and buybacks. What is there not to like? Over the last year revenue has fallen off a cliff, down 30%+ due

to a combination of a broader pullback in consumer discretionary spending, and more affluent consumers trying GLP-1 weight loss drugs.[10] The dividend was cut to offset the revenue decline and conserve cash for a strategic pivot. The consensus view is that GLP-1 drugs will permanently destroy all non-drug forms of weight loss. Maybe there is wisdom among the consensus, but we do not understand GLP-1s to be a permanent solution for weight loss due to side effects. In December Medifast announced an investment in LifeMD, a telehealth company that prescribes GLP-1s. The idea is to cross-sell Medifast products to GLP-1 patients transitioning off the drug. If in fact the pendulum has swung too far away from food-based diet programs, market leader Medifast will look like a deal at less than 5x earnings.[11]

New position - Veeva Systems (NYSE: VEEV, $170 cost basis)

Background: In late 2022 the S&P Biotech ETF (XBI) hit a 5-year low. At one point I remember seeing over half the microcap drug development universe selling below net cash. In a higher interest rate environment, the market did not believe the smaller drug stocks could raise the capital required for move through the FDA process.[12] I am not life sciences investor per se, but our profitable experience with Indivior and the severity of the selloff led me down a rabbit hole to see if there was something obvious to do after this time. In the end I realized that trying to underwrite potential outcomes of undeveloped individual drugs is too far outside my circle of competence. My takeaways from studying small cap drug companies:

1. The cost and time to develop a drug today are outrageous and choking off innovation.

2. The opportunity for software /generative AI to revolutionize drug discovery and the antiquated clinical trials process is enormous. AI will be able to speed up R&D processes around determining side effects, finding low risk adjacent targets, and discovering small drug molecule designs.

3. If IT spend generally is set to grow to over 5% of GDP within a decade, my guess is that IT spend within the approximately $800+ billion life sciences sector will grow faster.

4. The recent passing of the Inflation Reduction Act caps the net present value of major drugs. This incentivizes pharma companies to allocate resources to either big blockbusters, or M&A.

Some mind-blowing stats[13]

- $2.3 billion - estimated cost to take a drug from idea to commercialization. This number is somewhat misleading because it accounts for failures, but you get the point.

- 10 to 15 years - time it takes to develop a drug from start to finish.

- 37 - number of drugs approved by the FDA in 2022 (similar in 2023).

- 1 of out 10,000 drug ideas end up with FDA approval.

- 700 - new biotech startups per year.

[10] JDP research, estimates
[11] Capital IQ, JDP estimates
[12] Capital IQ, JDP estimates
[13] JDP research

Veeva

Veeva high-quality compounder selling software and cloud infrastructure to drug companies. Veeva is both a near-term bet on the bottoming of the life sciences sector and a longer-term bet on increasing cloud and software spend to drive much-needed efficiencies in life sciences. Veeva could be an outsized beneficiary in the long "tail" scenario if/when AI revolutionizes drug discovery.

Veeva was founded in 2007 by CEO Peter Gassner and Matt Wallach (board member). Veeva was a famous cash generative startup because it raised a total of only $7 million of venture funding before going public 5-years later in 2013 at a $4.4 billion valuation.

Veeva started as a specialty CRM product built on top of Salesforce. They used this wedge to expand into software that is now woven into the drug lifecycle of big pharma companies, from R&D to commercialization.

Veeva's products are divided into three areas: Development Cloud, Commercial Cloud and Data Cloud, covering everything from clinical operations to quality control (manufacturing), to the patient prescription database.

Key to Veeva's success has been a hyper focus on products designed for the regulatory challenges of life sciences industry. Other less-specialized software players like Oracle and Salesforce offer a hodgepodge of competing products but Veeva is seen as the gold standard, along with NYSE: IQV. Our research found that switching costs and lack of sector expertise from generalist vendors is usually not worth the risk of leaving the Veeva ecosystem for a better price.

Our entry valuation is a reasonable ~ 24x EV/ 2025 operating income and low-growth consensus expectations in the stock price.[14] Even if our excitement for IT spend in life sciences proves to be muted, Veeva's operating earnings should pick up to 10% to 12% annually as life sciences R&D spend normalizes. Our optimistic case is that Veeva's size, moat and position will allow for an eventual reacceleration of operating earnings growth to double the current rate. This scenario might not seem exciting at first glance, but the stock is a beneficiary of the next boom in drug discovery without taking drug development risk.

Looking forward

Going into 2024 there are plenty of reasons to be optimistic. Better visibility around inflation and the cost of capital is allowing management teams to pop their heads out the storm shelter and return to making longer duration investment decisions. M&A should also rebound in 2024 which is especially good for lower-growth sectors. Lastly, a decent chuck of the market is still trading below all-time-highs and there is an eye-watering amount of cash on the sidelines.[15]

As investors we are more concerned about the trajectory of our companies and less so about near-term results. But growth is reaccelerating in our portfolio especially for companies that had stagnated over the last two years.

If our portfolio was its own index, I would not be surprised to see our holdings report record profitability between 2024 and 2025. Of course, that does not mean prices will necessarily follow.

[14] JDP estimates
[15] JDP estimates

Although future is unknown, and risks are always lurking for stocks, I feel confident about our trajectory.

"The big money is not in the buying and selling, but in the waiting" --Charlie Munger, RIP.

Thank you for your trust and support.

Sincerely,

Jeremy Deal