

July 2021

Dear Fellow Investors,

The funds returned approximately 6% net of fees and expenses in the second quarter bringing YTD returns to approximately 21%. Returns will vary by fund, class, and investment date, so please refer to your statements for actual returns. This is just an interim mark. During the quarter, there were periods when we were up significantly more than 6%, and periods where we were down. We will continue to have down months, quarters, and years over time: this was just not one of them.

## **SPECIAL OPPORTUNITY FUND – SPAC-TACULAR**

July 1<sup>st</sup> marked the second closing of the Special Opportunity Fund, which focuses on providing risk capital to SPAC founding teams as well as investing in different parts of the SPAC capital structure. My family and the Royce family represent over 20% of the capital raised. We only accepted capital from existing limited partners, of which approximately one-third participated. In conjunction with the raising of the fund, I hired an analyst to focus on this space. I continue to be an investment committee of one, but given that there are over 500 active SPACs, it's very helpful to have another smart set of eyes focused exclusively on the space. We were fortunate to attract Kyle Campbell, a recent graduate from Columbia Business School's value investing program. Before Columbia, Kyle spent a decade serving in the military in an intelligence capacity. (I am as curious as you are as to what that actually means.) Kyle has been a great addition so far. In addition to being "good people," he is a thorough analyst who can do the quantitative work while also understanding the importance of the qualitative. Given the proliferation of SPACs and their unique features, Kyle is going to need all of the organizational skills, creative thinking, and grit he can muster. It is worth highlighting that the Special Opportunities Fund is meant to be symbiotic with the main fund. In fact, the new holding outlined in the appendix (MarketWise/MKTW) is held in both funds.

## **COMPOUNDING DISADVANTAGES**

In the Q4 2020 letter I wrote about the concept of "Fight Club," and said:

*Instead of thinking of a company as a group of assets managed by people, I think we are actually investing in a group of people managing assets. Those people are engaged in a series of fights with competitors while trying to scare off potential new entrants. Handicapping the fight is highly dependent on management, but also on existing assets, product positioning, balance sheets, and industry structure. These fights can be lopsided or can drag on, leaving both parties bloodied to a pulp. We want to own the strongest fighters in the easiest fights or the most underrated fighter with the best chance of surprising the lumbering, over-confident incumbents.*

I went on to note that if I could only focus on one aspect of a company, it would be management.

Recently, I have been thinking often about the disadvantages of being small. This has been informed by my time on the SharpSpring (SHSP) board of directors, but can most easily be seen in one of our portfolio companies, Barnes and Noble Education (BNED). We bought Barnes and Noble Education as part of a Covid recovery basket. The company was priced for bankruptcy, but I thought there were reasons to believe it would survive the pandemic and, if it did, our shares would be worth substantially more. Our investment thesis was predicated on survival and their core business of running bookstores

on college campuses. Unlike most retailers, the bookstores have favorable flexible leases such that the leases will not bankrupt the company even with no students on campus.

Barnes and Noble Education has been actively trying to capitalize on its relationships with colleges and grow its non-retail business. Management has been plowing capital into technology tools for college students, including a \$58M acquisition of study tool Student Brands. BNED's "student success hub," Bartelby, now houses all of their digital tools, which should have higher margins and recurring revenue. Bartelby provides students "access to step-by-step solutions to millions of textbook problems, a searchable database of solutions to homework questions, and subject matter experts on standby 24/7 when you're stuck." Since the Bartelby products can be advertised prominently in Barnes and Noble Education's campus stores, customer acquisition costs are lower as well. In a PowerPoint deck from five years ago, this was a reasonable strategy and a path to a better business.

We don't own the company for the Bartelby opportunity, and I am glad of that. The problem that Bartelby faces is Chegg. Barnes and Noble Education does not break out Bartelby R&D spending, but all indications from their 10K suggest that they spend less than \$10M per year while Chegg spends \$170M. This means that, over a three-year period, Chegg will outspend Bartelby by approximately \$500M. If Chegg is at all competent, their product advantages should compound over time. To put it another way, as a subscale competitor, our disadvantages will compound over time. Chegg does not charge students 20X more than Bartelby to use their product, they just have more scale, so they can spend more on R&D and therefore should have a better product at the same price. When a student chooses where to spend their dollars, they do not adjust for the resources available to a company; they just want the best product. I suspect that Barnes and Noble Education does not disclose the churn rate for Bartelby because it is embarrassingly high.

They recently replaced the leader of Bartelby. Like many sports teams, it is easier to replace the coach than the players. Bartelby vs. Chegg is like a small college team playing the Chicago Bulls with Jordan in his prime. They are technically playing the same game, but they aren't really. At this point, leapfrogging Chegg is almost unfathomable and would say more about poor execution at Chegg than execution at Bartelby.

People and valuation matter in investing, but I have increasingly come to appreciate relative strengths and the compounding disadvantages that can come with lack of scale. Of course, there will be times where product, market, team, and valuation line up, but I am gaining a greater appreciation for the benefits of scale, and I will approach the next subscale company more gingerly as disadvantages compound.

## TOP 5 HOLDINGS

Our top five holdings represent more than half of our total long exposure and therefore five greatly influence overall returns. Over the course of the quarter, we bought more shares in three of our top five— Digital Turbine (APPS), PAR Technology (PAR), and Elastic Software (ESTC). As none of these are new holdings and I have written extensively about them in previous letters, I will keep the updates very brief. A new holding is discussed in the appendix of this letter.

**PAR Technology (PAR)** – During the quarter, I had the opportunity to spend more time in person with PAR CEO Savneet Singh. For me, he hits all the right notes on building a team and making long-term investments to build out product offerings. If I am near a computer while he is speaking, I find myself wanting to purchase additional shares. Ultimately, talking a good game is a lot easier than actually realizing the vision. The company still has to prove that they can increase the pace



of installs, get traction on their payments business, and integrate their acquisitions. PAR will have to divest the legacy defense business and change their accounting practices to stop capitalizing software development. It is by no means time to take a bow, but Savneet has driven the company towards sufficient scale, made three acquisitions, and attracted talent. I think the PAR team has positioned the company well for the next decade of enterprise restaurant software.

**KKR (KKR)** – KKR remains an extremely resilient business with an A+ team enjoying the secular tailwinds of the migration of investable dollars toward alternative assets, where large allocators like the returns and love the muted volatility.

**Elastic Software (ESTC)** – Management continues to innovate and execute, rolling out new products and converting existing users from free to paid versions. They made adjustments to their licensing agreements, making it more difficult for Amazon to rip them off, and provided forward guidance that convinced investors that the growth train will continue to run for at least a few more years.

**ROKU (ROKU)** – We don't own Roku for the hardware, we own it for the streaming platform, which has favorable economics on both the Roku channel and other streaming service apps it hosts. In Q1, over 18 billion hours of content were streamed via Roku, including a more than doubling of hours streamed on the Roku channel itself, which reached over 70 million people. Given that Roku is a small player that controls very little content in the media landscape, my biggest concern has been that large players would stop or choose not to participate on their platform, reducing the customer value proposition. When the Peacock streaming service launched, they were not on Roku because they did not want to share revenue. When HBO's streaming service launched, they were not on Roku either because they did not want to share revenue. Eventually, both concluded that the distribution and ease of use provided by Roku made it such that a partnership ultimately made sense. It was recently announced that Apple would begin paying for an Apple TV button on the Roku remote... another indication of the powerful place Roku occupies in the streaming ecosystem.

**Digital Turbine (APPS)** – Our largest holding is Digital Turbine, which is covered by four sell side analysts. The company announced three acquisitions in during the first half of this year. In both the press release announcing the closing of the Fyber acquisition as well as in a subsequent investor presentation, Digital Turbine indicated that, on a pro forma basis including the acquisitions, revenue would more than triple while the share count would go up less than 15%. Only one of the four analysts provided any update to their clients. If tripling a business does not merit an update, I am not sure what does. I am forever grateful to Professor Jack McDonald for giving me the skills to analyze a business independent of the sell side, which can be very slow in the land of small caps.

At a sell side conference, management also indicated that their SingleTap product was gaining significant traction, with the CEO commenting that “[t]his has been a seven-figure business. And now when we talked a few months ago... we took us from a seven-figure business on a yearly basis to a seven-figure business on a quarterly basis. So great progress. We're seeing some nice scaling there, and I'm pleased to report today we're talking about seven figures on a WEEKLY basis.” The stock traded *down* on this news. For a company that did \$330M in revenue last year, it is odd that they are now run-rating more than \$50M a year on a high margin product that was barely a mention a year ago. Sell side reaction? Crickets. Even though it was our largest position and up more than 10X from initial purchases, I bought more shares. Profitable companies growing in the triple digits selling for five times current year revenues are rare. Time will tell if these were profitable purchases, but I think the outcomes are skewed in our favor.



## SHORTS

The partnership remained short major indices and no individual companies. We were short one SPAC-related company, but closed out the position during the quarter. While we do not set specific targets for short exposure, I suspect that we will short additional individual companies over the balance of the year.

## OUTLOOK

There are times when markets get ahead of themselves and when everything looks and feels expensive. There are times where every company I look at is a quick NO. This is not one of those periods. It requires only a modicum of optimism for me to see our largest holding, Digital Turbine, go up 70% in the next year given their growth rates, profitability, and discount to peers. It takes zero imagination for me to see our newest holding Marketwise go up 50% in the next year (write-up included in the appendix). I may be off in my analysis or there may be substantial multiple compression that drives a significant pullback in these stocks or the market, but, overall, I like what we own and think we are positioned for attractive returns over the long term.

Just as I have ended many of our letters... as volatility arises, I will attempt to take advantage of the opportunities it creates. We will continue to invest with a long time horizon, and we will continue to invest like it is our own money – because it is. Thank you for the opportunity to grow your family capital alongside mine.

Sincerely,

Scott Miller

## NEW HOLDING – MarketWise/Beacon Street Group (MKTW)

If you are reading this letter, you are not MarketWise’s target market. If you are reading this letter, you will look down on MarketWise’s products. If you are reading this letter, you have most likely never even heard of MarketWise. It should be noted that MarketWise is the new name for Beacon Street Group. MarketWise is a name that has existed for approximately one month.

What is MarketWise? It is a company going public via a SPAC (special purpose acquisition company). In their words,

*“Beacon Street Group (MarketWise) is a collection of dynamic companies offering our customers a diverse and comprehensive portfolio of independent investment recommendations, strategies, and tools across 12 customer facing brands. We are a leading content and technology platform for self-directed investors. Our subscription products deliver high-quality, independent financial research, analytical tools, and software primarily to retail investors across digital channels.”*

In sum, MarketWise provides financial newsletters and content like the Motley Fool, but more promotional.

If you see ads on Yahoo Finance touting Whitney Tilson as a “legend who bought Apple at 35 cents [who] says buy TaaS now,” that is from Empire Financial, one of Beacon Street’s companies. Their marketing is clearly aggressive, as it leaves out where Whitney sold his Apple shares. Other marketing refers to Whitney as one of the great financial minds and explicitly calls him “Whitney ‘The Prophet’ Tilson.” While I wish their marketing were less promotional, there is a market for stock information and recommendations for a growing group of self-directed investors. Are these investors really better off with CNBC’s Fast Money, Reddit, or Yahoo Finance providing recommendations? Whitney may or may not be a genius or a prophet as the ads claim, but he is certainly in the top decile in terms of market knowledge and his ability to articulate coherent investing insights and recommendations. His recommendations are grounded in facts, and he is not “pumping and dumping.” I agree that the ads are, at best, pushing the boundaries of decency, but there is a market for investing information subscription service(s).

MarketWise’s 110% net revenue retention in 2020 would indicate that actual paying customers see value in their products (remember, you are *not* the target market). The actual paying subscribers subscribe to an average of four products, another indication that they see value. If subscribers were simply being tricked by advertising, would they not only keep a single subscription but also subscribe to three additional products? Would customers spend more in 2020 than in 2019? Customer retention is above 90%.

I can save you some time on Google and let you know that there is an 18-year-old SEC lawsuit against one of their brands/personalities, Stansbury Research, and a Netflix “Unsolved Mysteries” TV show that explores the death of a former Stansbury employee.

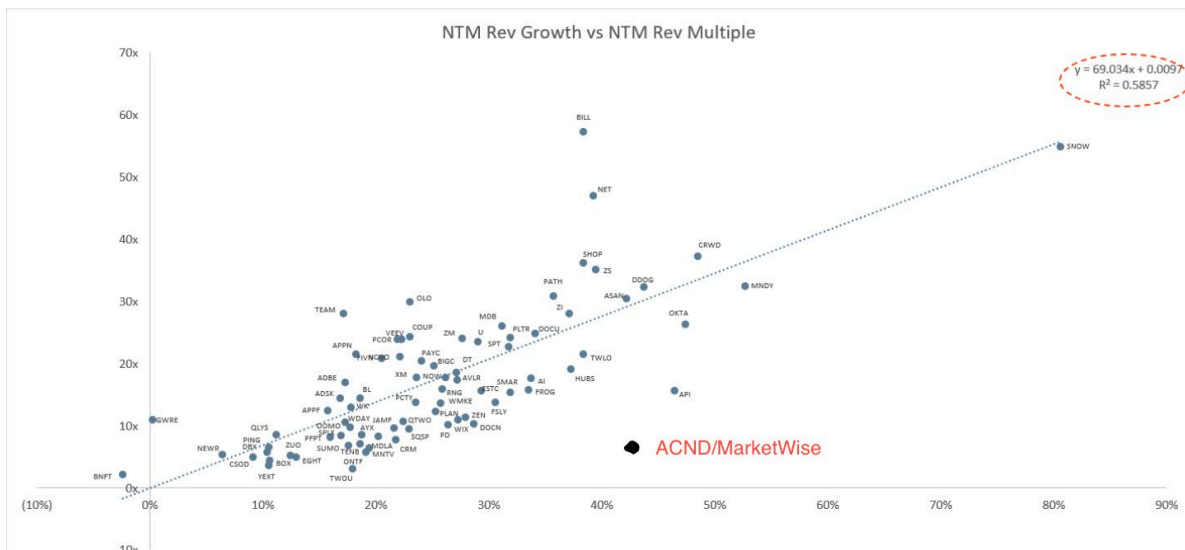
With some of the negatives out of the way, I will now mention that there are no other publicly traded financial newsletter businesses to my knowledge. I was surprised to see how good of a business it can be. Here are a few statistics:

- 86% gross margins (this is better than most software companies).
- Doubled Rule of 40 – software companies are considered healthy if they meet the Rule of 40 (growth rate + profit margin > 40%). MarketWise’s metric is currently > 80.

- Capital light – a \$50,000 investment 20 years ago was the only capital put into a business that will generate over \$550M in revenue this year.
- 20 straight years of profitability.
- Mid-20s historical revenue growth (accelerated recently) while remaining profitable.
- LTV/CAC > 5 (customer lifetime values are more than 5X what they cost to acquire them), with breakeven point at 7-9 months and cash recovered in 3 months.

Quantitatively, the business is attractive: it is asset light and cash flow generative with the ability to invest the cash at very high rates of return – a trifecta. Now, we are in a market where unicorns are priced like unicorns, and 30x revenue does not garner the guffaws that it used to. For MarketWise, we can actually look at cash flow. The company has guided to adjusted cash flow of \$211M (I think the adjustments are reasonable) on an enterprise value of approximately \$3B. The stock trades for approximately 15X cash flow, a fair price for an attractive business. However, I believe that the true cash-generating power of the business is understated in the valuation above. Sales and marketing (acquiring new customers) is the largest expense, equaling 59% of revenue in 2020 (\$219M, \$11M of which was stock-based compensation). There has been no updated guidance on this expense for 2021, but it is safe to say that sales and marketing will be materially higher as revenues are projected to grow from \$364M to \$561M and bookings from \$548M to \$751M. The vast majority of the sales and marketing spend is really growth capex. I estimate that for 2021, the portion of sales and marketing that is growth capex will be in excess of \$200M. If this capital were not spent on marketing, it would be taxed, so approximately \$160M of extra cash that would be generated if they were not pursuing growth. Ultimately, steady state, MarketWise would generate in excess of \$380M or a 12% free cash flow yield. If you look out a year or two, the numbers get even more compelling given the persistent high growth rates.

If MarketWise were a SaaS (software as a service) company, it would be valued on a multiple of sales. Given the high gross margins (86%), high growth rate (56% in last quarter), the attractive LTV/CAC, and profitability (will generate \$200M+ this year), it would almost undoubtedly trade north of 15X forward sales. MKTW currently trades for less than 6X current year sales and just over four times forward revenues. For illustrative purposes I have penciled in approximately where MarketWise would sit relative to the universe of SAAS companies tracked by the Clouded Judgement analysis newsletter.





Below is a comparison of MarketWise to the highest multiple SAAS stocks. You will note that it compares very favorably vs. the group on growth rates, gross margins, and operating margins for 1/6th the entry multiple.

#### Top 10 EV / NTM Revenue Multiples

Company	EV / NTM Rev	NTM Rev Growth	Gross Margin	Operating Margin	FCF Margin
1 Bill.com	57.2x	38%	74%	(26%)	(18%)
2 Snowflake	54.9x	81%	58%	(92%)	(8%)
3 Cloudflare	47.0x	39%	76%	(21%)	(10%)
4 CrowdStrike	37.3x	49%	74%	(10%)	34%
5 Shopify	36.3x	38%	53%	8%	18%
6 Zscaler	35.2x	40%	77%	(31%)	23%
7 Monday.com	32.5x	53%	86%	(89%)	(21%)
8 Datadog	32.3x	44%	78%	(5%)	20%
9 UiPath	30.8x	36%	85%	(44%)	5%
10 Asana	30.5x	42%	88%	(77%)	(60%)
Average	39.4x	46%	75%	(39%)	(2%)
Median	35.7x	41%	77%	(29%)	(2%)

MarketWise	5.4x	54%	86%	NM*	28%
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(Source: [clouddedjudgement.substack.com](https://clouddedjudgement.substack.com), a weekly data-driven analysis of SaaS companies)

While I don't expect Beacon Street/MarketWise to be valued like a software company, my point is that our entry valuation is not demanding, particularly if the growth is sustainable and the projections are reasonable. We should not have significant multiple compression and should have a chance to appreciate roughly in line with revenue/earnings growth, which is likely to be 25%+.

Are the projections for this year reasonable? The main revenue drivers for MarketWise are the number of subscribers and the revenue per subscriber. The company ended 2020 with 857K subscribers. During their analyst day this past April, they disclosed that 144K subscribers were added in the first quarter, so to meet their full-year guidance of 1.084M subscribers will require them to add just 83K subscribers for the remainder of the year. The subscriber number is important because it drives the revenue number, which was revised upwards in March to \$561M for 2021.

When asked by an analyst if the guidance given in March was conservative, the CFO said that "March was another strong month for subscriber growth.... So almost instantly our increased projection still looks pretty conservative relative to the – to our actual performance. You know, we did that (raised guidance) prior to us knowing what March numbers were. So short answer is, it is conservative."

While the 2021 numbers may be conservative, what does the future hold? With 20 straight years of profitability and revenue growth in 18 of the past 20 years, there is some historical precedent to suggest that the business will not fall apart. Historical

growth rates were in the mid-20s and the growth over the next two years is projected at 41% per year. In the first quarter of 2021, revenue grew 56%. Are they just pulling demand forward and growth will collapse? It is possible, as one-quarter of the Q1 revenue increase was driven by lifetime subscriptions, but lifetime subscriptions are not a new offering – they typically have small annual membership dues associated that are recognized over five years. The company has added employees and products, and, perhaps most importantly, they have significantly invested in their free-to-paid channel. As the CEO said,

*“We’ve got a massive new distribution channel (free to paid) that we are only beginning to harvest. We have 10 million people in this community, and we should be able to convert a lot more than 200,000 of those a year to pay. Our early returns are 200,000 a year coming from that channel. So we’re kind of getting from the standpoint that we started to harvest these returns, it is a dramatically different company today than it was even 24 to 36 months ago.”*

Conversations with management provided more context on the growth of the free-to-paid channel. The company did not promote their free products historically due to the resulting delays in receiving cash / new paying subscribers. In 2018, they began to ramp up the efforts and grew the free product recipients from approximately 1M to 2.7M by year-end. Through testing and experimentation, they have found that focusing on converting free customers to paying customers can make economic sense for MarketWise, leading management to make a significant investment in growing this audience segment. As indicated in the Q1 press release, “Our Free Subscriber pool is now responsible for roughly 40% of our new Paid Subscribers, so the continued momentum in this area is fueling additional future growth in Paid Subscribers.” As of the end of Q1, free product subscribers had grown to total 10.9M relationships, an asset that does not appear on the balance sheet but clearly has monetization potential and increases the likelihood that growth persists.

Will MarketWise continue to grow at such high rates? I don’t know, but it is clear they have invested in infrastructure, added new products that enable cross-selling, and have the capital and cash flow to make additional growth investments such that the possibility of future growth is not fanciful. I realize that this is a SPAC and that all projections are to be viewed with skepticism, but I don’t think we are paying for growth at a 12% normalized free cash flow yield, and I think, on a risk-adjusted basis, it is highly likely that we will see continued growth with no additional capital required.

### **Top Beacon Street / MarketWise Risks**

Legal/ regulatory – the newsletters operate under a “publisher exemption” that provides broad protections. Copy is run through a legal department before distribution. There have been lawsuits regarding the content distributed, but those were generally 10+ years ago. Presumably, a tightening of allowed copy would present headwinds for the company. Similarly, a suit for more recent content could be filed to the detriment of public shareholders.

Competitive Landscape – the emergence of Twitter subscription products and Substack provides authors with alternative channels to build and monetize a following. Given the older demographic of Beacon Street’s customer base, these competitors should not be a large source of cannibalization, but the landscape is changing and could impose threats.

Talent Drain – with 160 products, equity grants to popular editors, and an attractive proposition (we take care of everything but the content), it is unlikely that there is a large talent drain, but clearly the IP could leave the company.





MarketWise has higher gross margins (86%), lower churn (5%), higher growth rates, faster CAC payback (7-9 months), and less capital intensity than the vast majority of software companies that I look at. It is not a software company, and is not getting a software multiple, but it is 100% digital and can provide very attractive returns from organic growth and exceptional returns in the event of a multiple re-rating. Most SPACs these days are “trading down” upon deal completion. MarketWise may very well follow this pattern, but ultimately, time should be our friend. This business requires no capital, is being acquired at a reasonable multiple, and has a 20 year history of profitability and attractive growth. We may not be interested in having MarketWise content in our inboxes, but it has a spot in our portfolio.



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