November 20, 2020

Dear Partners and Friends,

We are pleased to share our latest reflections on our businesses and investment strategy. We hope this letter gives you a better sense of who we are, how we invest, and our latest thinking on various topics pertinent to our Partnership.

A Framework for Understanding Optionality

As fiduciaries, one of our principal responsibilities is to protect and grow our Partnership's capital at high absolute rates relative to passive alternatives. As equity investors, this often equates to finding companies where the current valuation sufficiently misprices the Business' future growth and profitability. We then maximize expected return by constructing a portfolio that accounts for the varying returns and associated risks. We accomplish this by building a concentrated portfolio of 5-10 equity stakes in high-growth, high-quality businesses that provide superior value propositions to their ecosystem constituents, and are operated by strong management teams.

Our businesses tend to grow revenue, gross profit, and long-term free cash flow per share at high rates—our target is typically 30%+ along these metrics. Many attributes make for a great long-term investment, but we want to focus this letter on one attribute: Optionality.

Our definition of Optionality is derived from that of Real Options, which are defined as *"an economically valuable right to make or else abandon some choice that is available to the managers of a company, often concerning business projects or investment opportunities."*[1] These options are "real" because, unlike most financial options, Real Options are typically tangible or intangible assets, like a factory or software, instead of financial instruments.

While Real Options are relevant from the perspective of the Business manager, we are interested in defining this phenomenon from the investor's perspective. As a result, we modify the definition to be *"the expected value of a current or future investment that is unknowable or difficult for the market to discern."* We define the latter as "Optionality."

Op•tion•al•i•ty *ShawSpring Definition*

The expected value of a current or future investment
that is unknowable or difficult for the market to discern.

Similar to Real Options, Optionality is an investment made by a Business, such as a new product launch, expanding to a new geography, or starting a new business unit. The fundamental difference between Real Options and Optionality is that investors operate in an efficient market environment. This means that unlike the Business which can abandon an investment, minority shareholders are beholden to how the market views the value creation or destruction of such investments.

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[1] Investopedia

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We think that the market aptly prices a Business whose information is properly disclosed to the public—as is typically the case for the core business. Take for example, the growth of a brick-and-mortar retailer expanding in its home geography; while this kind of expansion can result in satisfactory shareholder returns, trading on this information is mostly acting on the explicitly analyzable core business. Therefore, we must incorporate the market's expectations into our definition; to be considered an "option" there needs to be some mystery to the consideration, or it would likely already be incorporated in the Business' valuation. This is why Optionality needs to be *"unknowable or difficult for the market to discern."*

Although quantified on an absolute basis, the impact of Optionality is relative to the Business' current size. The key, then, is to identify situations where Optionality's expected value is high relative to that of the existing Business.

At ShawSpring, we have benefited from Optionality, while also enduring opportunity costs from incorrectly estimating Optionality in certain circumstances. What became clear through our research is that over a long enough time horizon (typically, 3-5+ years), a significant amount of the future value creation can come from Optionality. As a result, we sought to develop a generalizable framework that would enable us to better underwrite Optionality in our research process.

The Different Types of Optionality

We have identified four types of Optionality that are applicable to our investment analysis efforts: (1) New Business / Businesses, (2) Product or Category Expansion, (3) Strategic Shift / Evolution, and (4) Geographic Expansion.

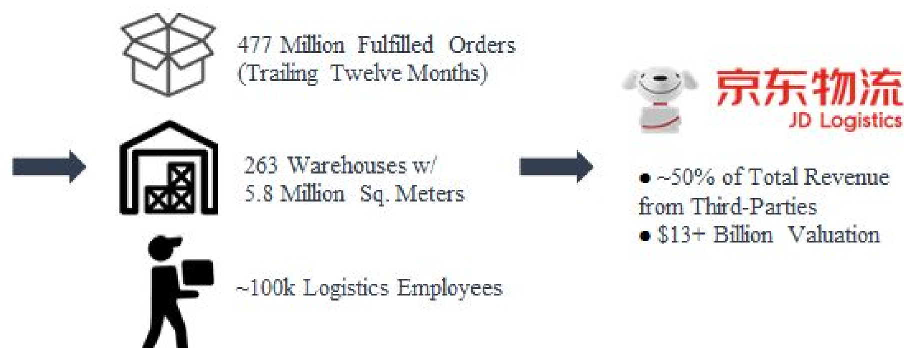
Optionality Type #1 — New Business / Businesses

Optionality from new business creation typically stems from the company leveraging the advantages and infrastructure of its core business. For example, leading ecommerce retailers Amazon and JD.com have formed logistics businesses leveraging the infrastructure that underpin their respective retail businesses. Other examples include cloud computing (most notably, Amazon Web Services ("AWS"), along with Tencent and Alibaba) and digital payments (such as Tencent, Alibaba, MercadoLibre, Sea Limited, and so on). For this type of Optionality, analyzing these companies' operating costs can be fertile grounds for identifying potential new businesses.

For example, JD.com recorded RMB 22.3 billion (~$3.4 billion) in trailing-twelve-months fulfillment expenses a month prior to the spin-off of JD Logistics as a standalone business.[2] While these fulfillment expenses accounted for more than half of JD.com's total gross profit, in reality the fulfillment expenses indicated investments in logistics infrastructure that JD.com would leverage to create JD Logistics. As of Q3 2020, JD Logistics generates ~50% of its revenue from third party customers and is valued at $13+ billion. Once viewed as a cost center, JD Logistics is now a profit generator for the entire JD.com Group.

[2] JD Group SEC filings. Financials are as of Q1 2017.

JD.com Income Statement (TTM)	
RMB mm	Q1 2017A
Revenues	282,442
Cost of Revenues	238,476
Gross Profit	43,966
Operating Expenses	
Fulfillment	22,299
Marketing	11,166
Technology & Content	5,826
General & Administrative	5,048
Total	44,339
Operating Income	(373)



Sources: JD.com SEC filings, ShawSpring research

Companies like JD.com have the advantage of justifying their investments because they are supporting the main business (typically ecommerce) and accelerating their scale on the demand-side by leveraging their existing customer bases. This is not only a capital-efficient way to scale, but it also increases the probability of success, as the first and best customer for the new business is typically the legacy business. Notably, Amazon is the first and best customer for AWS.

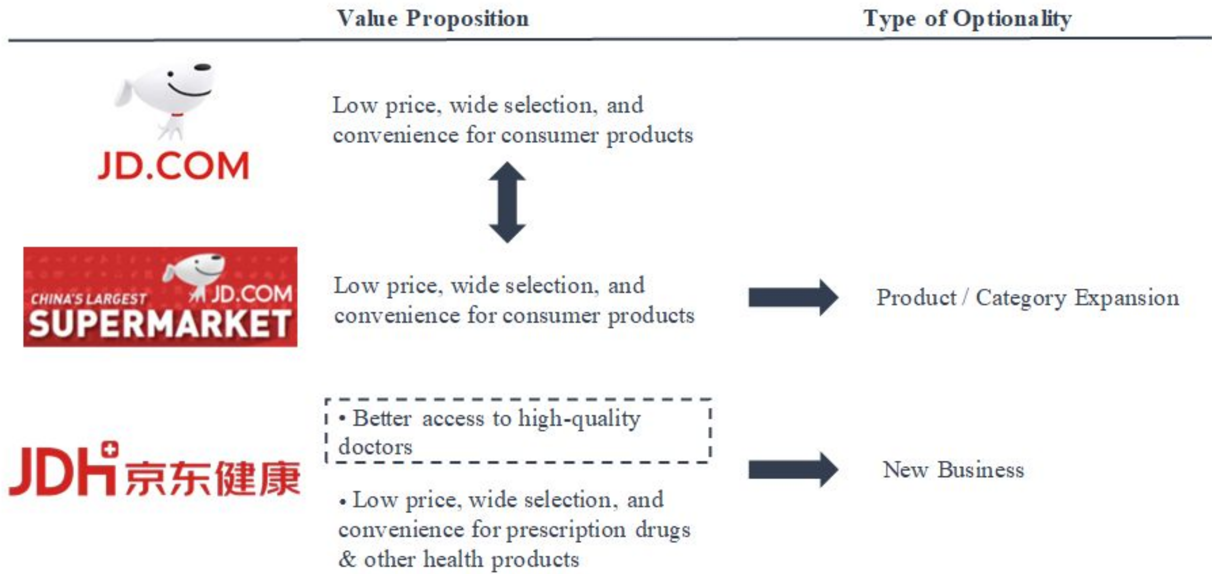
ByteDance exhibits a similar dynamic. Its initial product was Toutiao, a Chinese news aggregation platform, which differentiated itself from traditional news platforms by building algorithms rooted in machine learning in order to personalize news recommendations to its users. Today, Toutiao has accumulated a massive user base of over 200 million monthly active users who spends an average of 74 minutes per day on its app.[3] The company realized that its expertise in machine learning could be leveraged to other verticals. Armed with their algorithms, ByteDance created Douyin (known as TikTok outside China), a category-leader in short-form video.

The odds of a company creating a massively successful second or third business from scratch is low. Leveraging existing aspects of an established business can increase the chances of success.

Optionality Type #2 — Product / Category Expansion

This form of Optionality occurs when a business tries to improve its customer value proposition by adding new products or categories. Product / category expansion differs from new business Optionality in that these new products or categories are *complements* to an existing offering, and not serving a new customer or market. For example, JD Health—JD.com's digital health business—is included in new business Optionality rather than category expansion, because even though it leveraged JD.com's assets (such as JD.com's customer base, inventory procurement, logistics assets) it is servicing a consumer's healthcare needs, not their retail needs. Therefore, we define it as a new business, not category expansion. On the other hand, we include JD.com's expansion into groceries and other fast-moving consumer goods ("FMCG") as category expansion since it is a complement to JD.com's existing consumer retail value proposition.

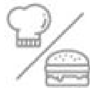
[3] Expanded Ramblings



Source: ShawSpring Research

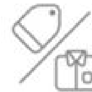
Two notable examples of product or category expansion Optionality are software businesses adding new modules and online dating businesses adding product features that increase the odds of successful user matches. For example, Tinder's introduction of its "Boost" feature (which allows users to jump to the front of the sort order in their local region for 30 minutes) in 2016 is an excellent example of product expansion Optionality.

Frequently, this type of Optionality eventually evolves into verticalization. Verticalization occurs when a business scales a successful horizontal business model but realizes that it can better serve a subset of customers with a vertical-specific offering. For example, Square's founding mission is to democratize payments for all small merchants. Square has been wildly successful in fulfilling this mission with over 3 million merchants and over $100 billion in run-rate total payment volumes. However, Square found that some of its larger verticals, specifically restaurants and retail, needed more customized solutions beyond their flagship turn-key offerings to assist in running these specific businesses' daily operations. This spawned "Square for Restaurants" and "Square for Retail," two vertical business units that offer software solutions to cater to the merchants in these categories.



SQUARE FOR RESTAURANTS

Features
- Menu management
- Square Online
- Curbside pickup & delivery integrations
- Order manager



SQUARE FOR RETAIL

Features
- Inventory management
- Square Online
- Team management
- In-store pickup

Sources: Square, ShawSpring Research

Another variation of product / category expansion Optionality is moving "up-market" to cater to larger enterprise customers. This typically occurs with businesses whose origins are in selling products to smaller businesses in order to gain rapid initial adoption. Once product-market fit is achieved among small-business customers, these businesses often evolve their products to cater to the more sophisticated, idiosyncratic needs of larger companies. A recent example is Vimeo, which started out by offering video editing and distribution tools to independent video creators but has since created an enterprise subscription tier to better target the video needs of larger companies, including Fortune 500 companies. This Optionality can be quite powerful since enterprise clients can generate significantly higher revenues than small businesses. For example, Vimeo's average revenue per user is $200+ per year, but the average revenue per enterprise account exceeds $15,000 per year.[4]

Product / category expansion's success can be identified *ex-ante* by focusing on the customers' objectives, and by determining whether the degree to which current or potential new products or services fulfils that ultimate objective. For example, a Spotify customer's objective is to have an easily-accessible medium to consume audio. With this framework, expanding into podcasts was an inevitable move for the music

[4] IAC SEC filings

streaming platform, even before Spotify entered the sector publicly with its acquisition of podcast network Gimlet Media in February 2019.

Optionality Type #3 — Strategic Shift / Evolution

This type of Optionality arises when a company recognizes a natural evolution away from (but still related to) their current business towards one with a superior customer value proposition.

Netflix's business evolution is one of the most explicit examples of how clever entrepreneurs can exploit this type of Optionality. Currently, Netflix is viewed as the dominant over-the-top (OTT) provider globally, but its future dominance was not obvious 14 years ago when it was a DVD rental company. As the company shifted to OTT and then to original content, the market was initially skeptical given the cash burn and uncertainty around long-term unit economics. The transition was difficult to underwrite, but unlocked massive value once Netflix's competitive advantages became evident to the market.

Adobe's transition from on-premise to software-as-a-service ("SaaS") is another great example of this type of Optionality. In 2012, Adobe announced that it was transitioning its Creative Suite into Creative Cloud, a SaaS-type model. This strategy shift was massively unpopular with its shareholders initially as it meant undertaking significant capital investment which essentially put a halt on revenue growth and more than halved operating profits. The transition was also projected as unlikely to succeed because, at that time, it was rare for a legacy on-premise player to successfully pivot to SaaS. However, management stuck to their vision and the SaaS transition allowed Adobe to reaccelerate revenue growth to 20%+ and roughly tripled operating profits since 2012. Because of the relatively low monthly costs of Creative Cloud compared to the massive one-time fee of its on-premise counterpart, Adobe has managed to defend its dominant position from potential SaaS entrants.

This type of Optionality typically only comes into focus after the management team commits to a strategic shift. Once communicated, this can remain Optionality until it becomes evident to the market whether the move will result in value creation.

Optionality Type #4 — Geographic Expansion

Geographic expansion occurs when a company expands to a new region or country in hopes of replicating its success from its core market. Optionality from geographic expansion rarely comes from within the country—at least not for public companies with enterprise values exceeding $1 billion. This domestic expansion is typically part of the known story. More often, geographic Optionality is the result of a business expanding to a country or region that is new or unexpected. Shopee in Brazil or Garena's *Free Fire*'s expansion outside Southeast Asia are notable examples of geographic expansion Optionality for Sea Limited.

Another good case study can be found in Starbucks' expansion into international markets. When Starbucks went public in 1992, it was largely a North American coffee chain with locations across the U.S. and select Canadian markets. However, there was embedded Optionality from geographic expansion, which materialized when it entered Japan and Singapore in 1996 and then China in 1999. Up until this announcement, Starbucks shareholders were likely investing on the premise that Starbucks was a domestic business, where growth would follow as the Business' success grew stores and multiplied earnings through the long-term profits per store. From 1992 to 1996, Starbucks grew its store count, revenue, and operating profit at 50%+ compound annual growth rates ("CAGR"). However, entering and

scaling its business in international markets was largely unconsidered. Today, geographic expansion accounts for 48.2% of Starbucks' store count.[5]

Sources: Starbucks SEC filings, ShawSpring Research

Over the past 24 years, Starbucks grew its total stores at an impressive 15.6% CAGR. Importantly international expansion added 3.1 percentage points to Starbucks' annual growth, resulting in 15,727 new stores added to the company's footprint. Importantly, Starbucks only added 191 fewer stores internationally than in its core North American markets—demonstrating the power of geographic expansion Optionality.

Starbucks' Store Growth (Number of Stores)

	FY 1996	FY 2020	Growth	CAGR
North America	1,013	16,931	15,918	12.4%
International	2	15,729	15,727	45.3%
Total	1,015	32,660	31,645	15.6%

Sources: Starbucks SEC filings, ShawSpring Research

<u>Optionality Case Studies</u>

Inherent to identifying Optionality is finding circumstances in which the investment's expected value is difficult for the market to estimate. This can occur for a handful of reasons:

1. Opaque disclosure when the holding company does not disclose the necessary information.
2. An under-monetized asset which blurs the investment's long-term revenue and earnings power.
3. An unannounced merger or acquisition that is difficult to forecast *ex-ante*.
4. Poor current unit economics and uncertain competitive positioning as the business is scaling.

A few well-known examples of Optionality include Amazon prior to breaking out Amazon Web Services' ("AWS") financials; Match Group going public with slow growth and an unproven, unmonetized asset in Tinder; and Sea when Shopee's unit economics indicated an unfavorable future.

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[5] Starbucks SEC filings. "North America" is defined as the U.S. and Canada. "International" is defined as China, Japan, U.K., and other.

Opaque Disclosure: Amazon Web Services Prior to Its "IPO"

Today, AWS is thought of as the dominant cloud computing provider globally with 48% market share,[6] generating $42.6 billion and $12.6 billion in trailing-twelve-months revenue and operating income, respectively.[7] However, prior to 2015, AWS was lumped into Amazon's two reporting segments at the time—North America and International—which included Amazon's traditional retail business. This obfuscated the market's ability to properly estimate AWS' revenue and operating income, and therefore, its ability to correctly value the business. This changed once Amazon broke out AWS into its own segment, beginning Q1 2015. Nearly overnight, it became evident to the market that AWS was a fast-growing business with attractive profitability despite being in the earlier phases of scaling. Importantly, the market finally had verified financial metrics to value the business.

Amazon's Segment Results (USD mm)—Old		
North America	**2013A**	**2014A**
Revenue	44,517	55,469
Y/Y Growth		24.6%
Operating Income	1,886	2,105
Y/Y Growth		11.6%
Operating Margin	4.2%	3.8%
International	**2013A**	**2014A**
Revenue	29,935	33,519
Y/Y Growth		12.0%
Operating Income	107	(297)
Y/Y Growth		-377.6%
Operating Margin	0.4%	-0.9%
Total Company	**2013A**	**2014A**
Revenue	74,452	88,988
Y/Y Growth		19.5%
Operating Income	1,993	1,808
Y/Y Growth		-9.3%
Operating Margin	2.7%	2.0%

Amazon's Segment Results (USD mm)—New		
North America	**2013A**	**2014A**
Revenue	41,410	50,834
Y/Y Growth		22.8%
Operating Income	1,166	1,292
Y/Y Growth		10.8%
Operating Margin	2.8%	2.5%
International	**2013A**	**2014A**
Revenue	29,934	33,510
Y/Y Growth		11.9%
Operating Income	154	(144)
Y/Y Growth		-193.5%
Operating Margin	0.5%	-0.4%
Amazon Web Services	**2013A**	**2014A**
Revenue	3,108	4,644
Y/Y Growth		49.4%
Operating Income	673	660
Y/Y Growth		-1.9%
Operating Margin	21.7%	14.2%
Total Company	**2013A**	**2014A**
Revenue	74,452	88,988
Y/Y Growth		19.5%
Operating Income	1,993	1,808
Y/Y Growth		-9.3%
Operating Margin	2.7%	2.0%

Sources: Amazon SEC filings, ShawSpring Research

The day after reporting earnings, Amazon's market capitalization increased by $26.6 billion (a 14% appreciation) with nearly all of it due to the "IPO" of AWS. In the roughly five years since, AWS's valuation has increased to $1 trillion (according to estimates) —a 38x increase, or 91.7% compound annual return.[8]

[6] Gartner, Goldman Sachs
[7] Amazon SEC filings. As of Q3 2020.
[8] Goldman Sachs

An Under-Monetized Asset: Tinder at Match IPO

At the time of its IPO, Match Group's financials displayed a tepid growth story. Match Group was only growing revenue 6% year-over-year, and while the company was generating attractive 31%+ EBITDA margins, EBITDA was down 9% year-over-year.[9]

Match Group (MTCH)	
Trailing Twelve Months (USD mm)	**Q3 2015A**
Revenue	881
Y/Y Growth	6.4%
Gross Profit	705
Y/Y Growth	6.0%
Gross Margin	80.0%
EBITDA	276
Y/Y Growth	-9.3%
Margin	31.3%
Free Cash Flow / Share	0.81

Sources: Match Group SEC filings, ShawSpring Research

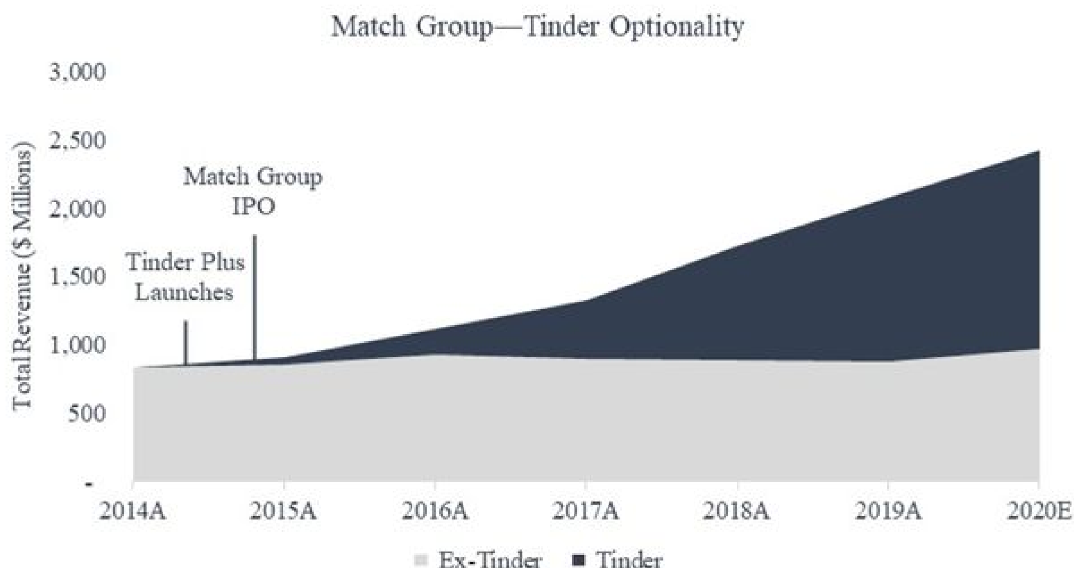
As a result, the market assumed linearity on a go-forward basis given the relatively uninspiring run-rate financial performance. Match Group was thought of as a solid business, but its traditional stalwart brand—Match.com—was experiencing headwinds from the proliferation of soft paywall brands and from the transition to mobile.

Match Group did have a potential crown jewel in Tinder, which in only a few years had revolutionized mobile-native dating for people under 25-years-old. However, Tinder was only founded ~3 years prior to Match Group's IPO, and the market had concerns about its sustainability and capacity to monetize given its concentration in the younger, lower-income demographic. Furthermore, at the time of the IPO, Tinder's financials were not disclosed by Match Group. Tinder's financials eventually were disclosed, but the market found that Tinder was only generating ~3% of Match Group's total revenue. At the time, Tinder's monetization potential was viewed by the market as something unlikely to move the needle.

These factors wove the narrative that Match Group was a solid business with good profitability, but would likely struggle to maintain sufficient revenue growth to generate 15-20%+ returns in the long run. As a result, Match Group's valuation of ~15x EBITDA and a 5% after-tax free cash flow yield reflected this perceived reality.

The market was correct in its concerns about Match Group's growth ex-Tinder, and in actuality, overestimated its growth. Since its IPO, non-Tinder revenue has only grown at a compound annual growth rate of 1.7%. However, what the market underestimated was the Optionality that Tinder provided. As shown in the following chart, Tinder went from a *de minimis* revenue contributor shortly after it launched its base subscription tier, Tinder Plus, to a nearly 60% revenue contributor in ~5 years.

[9] Financials are trailing twelve months as of Q3 2015. Financials exclude The Princeton Review which was non-core to Match Group, accounted for ~10% of revenue at the time of the IPO, and was sold to ST Unitas in March 2017.



Sources: Match Group SEC filings, ShawSpring Research

Driven predominantly by Tinder, Match Group has grown revenue, EBITDA, and free cash flow per share at a 21.0%, 25.6%, and 23.6% CAGR, respectively.

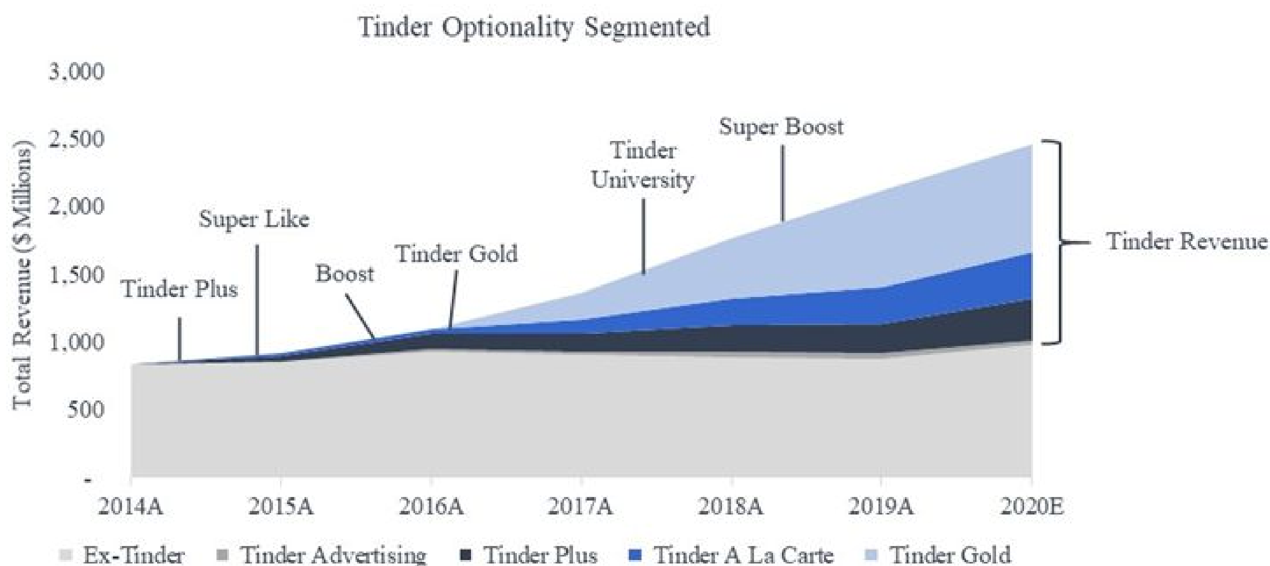
Match Group (MTCH)			
Trailing Twelve Months (USD mm)	**Q3 2015A**	**Q3 2020A**	**CAGR**
Ex-Tinder Revenue	845	921	1.7%
Y/Y Growth	2.1%	8.3%	
Tinder Revenue	36	1,366	106.8%
Y/Y Growth	N/M	23.0%	
Total Revenue	881	2,287	21.0%
Y/Y Growth	6.4%	16.6%	
Gross Profit	705	1,682	19.0%
Y/Y Growth	6.0%	14.8%	
Gross Margin	80.0%	73.6%	
EBITDA	276	863	25.6%
Y/Y Growth	-9.3%	16.6%	
Margin	31.3%	37.7%	
Free Cash Flow / Share	0.81	2.35	23.6%

Sources: Match Group SEC filings, ShawSpring Research

What makes Tinder such an interesting case study is that it also displayed multiple forms of Optionality over the years. In addition to Tinder Plus, the business also displayed Optionality through new product launches, like Boost, which resulted in higher à la carte revenues, and the eventual creation of a new subscription tier—Tinder Gold—in June 2017. Match Group expects to roll out Tinder Platinum by the end of 2020.[10]

This highlights an important point: *sometimes optionality begets optionality.*

[10] Perez, Sarah. "Match Confirms Plans for Tinder Platinum, a New Top-Level Subscription for Power Users, Arriving Q4." *TechCrunch*, TechCrunch, 5 Aug. 2020, techcrunch.com/2020/08/05/match-confirms-plans-for-tinder-platinum-a-new-top-level-subscription-for-power-users-arriving-q4/.



Sources: Match Group SEC filings, ShawSpring Research

Shopee's Poor Unit Economics & Uncertain Competitive Positioning

We initiated our investment in Singapore-based Sea Limited the day after it reported its Q4 2018 financial results in February 2019. At that time, Shopee's financial results showed anything but a dominant ecommerce company. In 2018, Shopee generated a low 2.8% take rate with -$162 million in gross profit and $860 million in total operating losses. Shopee lost nearly $3 for every $1 in revenue that it generated.

Sea Limited (2018A Financials by Segment)				
USD mm	**Garena**	**Shopee**	**Others**	**Consolidated**
Revenue	661	291	97	1,049
Y/Y Growth	33.3%	NM	NM	89.3%
Gross Profit	353	(162)	5	196
Y/Y Growth	42.3%	NM	NM	-0.5%
Gross Margin	53.4%	-55.7%	5.2%	18.7%
Adjusted EBITDA	263	(860)	(97)	(694)
Y/Y Growth	50.3%	NM	NM	NM
Margin	39.8%	-295.6%	-100.0%	-66.2%

Sources: Sea Limited SEC filings, ShawSpring Research

The market was skeptical of Shopee's cash burn and whether its unit economics were viable long-term. Underpinning this was uncertainty over Shopee's competitive positioning versus Alibaba Group's Lazada regionally and SoftBank-backed Tokopedia in Indonesia. As a result, the market ascribed little-to-no value to Shopee and was valuing the entire company at <20x Garena's 2018 EBITDA and ~10x 2019 expected EBITDA based on management's guidance.

To us, the Optionality in Shopee provided an interesting setup—we could acquire what we believed, in our base case, was a business scaling to become the dominant ecommerce platform in the region for what the market was valuing as a long-tail event. While the market saw a business with a low take rate,

negative gross margins, and cash burn approaching a billion dollars, we saw a business that was investing to scale its ecosystem, which, if it could build competitive advantages, would have mature economics that looked something like the following:[11]

Shopee's Financials vs. Steady-State		
USD mm	2018A	Steady-State
Gross Merchandise Value	10,279	10,279
Revenue	291	1,028
Take Rate	2.8%	10.0%
Gross Profit	(162)	720
Gross Margin	-55.7%	70.0%
Adjusted EBITDA	(860)	360
Margin	-295.6%	35.0%

Sources: Sea Limited SEC filings, ShawSpring Research

Importantly, we estimated that we were paying nearly nothing for a business we thought was worth ~$16 billion on a normalized unit economics-basis. This compared to Sea Limited's total enterprise value of $5.1 billion at the time—which was entirely accounted for by Garena. This was a situation where the *Optionality was worth 3.1x Sea's entire valuation*.

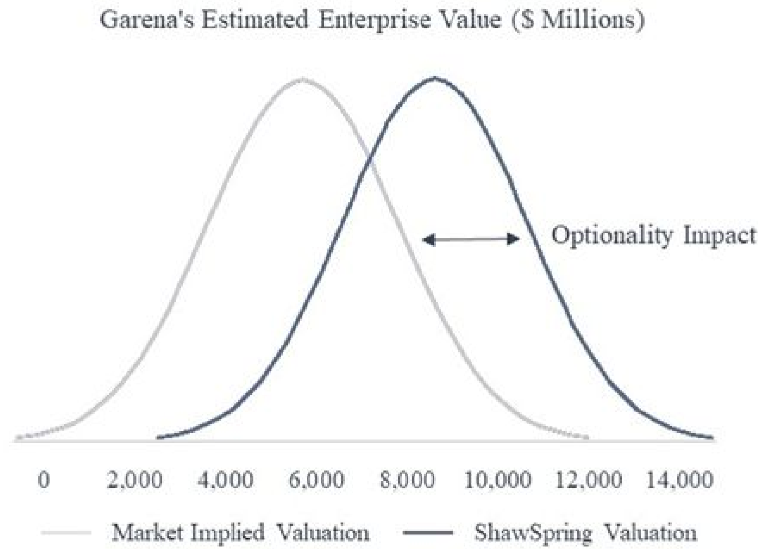
While this alone made Sea Limited one of the more appealing investment candidates we have come across since starting the Partnership in 2014, there was another form of Optionality present that made it even more unique: Garena's internally developed Battle Royale game *Free Fire* was just starting to monetize and its valuation implied the market was underestimating the impending inflection in growth, along with the lift in EBITDA margins stemming from *Free Fire* being self-developed (basically, Garena eliminated the 20-30% licensing fees it pays the developer when it acts as the publisher).

Optionality in the form of *Free Fire* showed hints of potential value creation throughout 2018 as it scaled its user base but had yet to push monetization. For example, in Q3, Garena's reported total active user base grew 155% year-over-year, while its active paying users base only increased 11% year-over-year.[12]

We saw Optionality due to Garena's expertise in monetizing mobile games and *Free Fire*'s undermonetized user base of 40 million highly-engaged users.[13] This was a variant perspective compared to that of the market: *Free Fire*'s monetization—and the magnitude of eventual revenue generation—was difficult to predict and therefore not included in Sea Limited's embedded expectations.

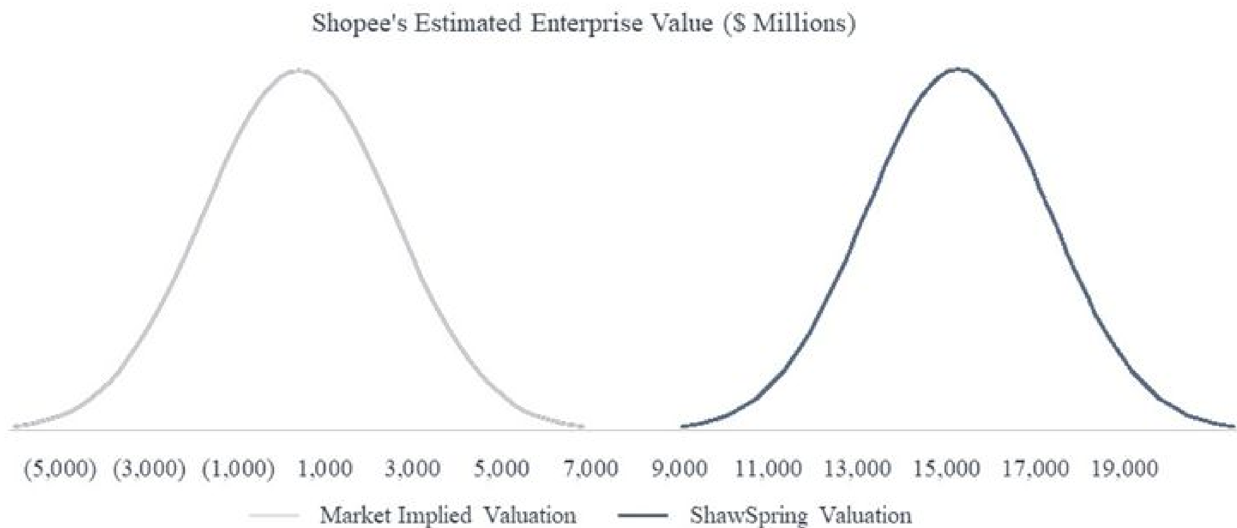
The two distribution-of-outcome graphs below demonstrate the role of Optionality in Garena's valuation, with Optionality shifting the expected return favorably to the right.

[11] Steady-State financials only include our estimate for marketplace and exclude direct retail and value-added services.
[12] Sea Limited SEC filings; metrics as of Q3 2018.
[13] Sea Limited SEC filings; defined as "peak daily active users."



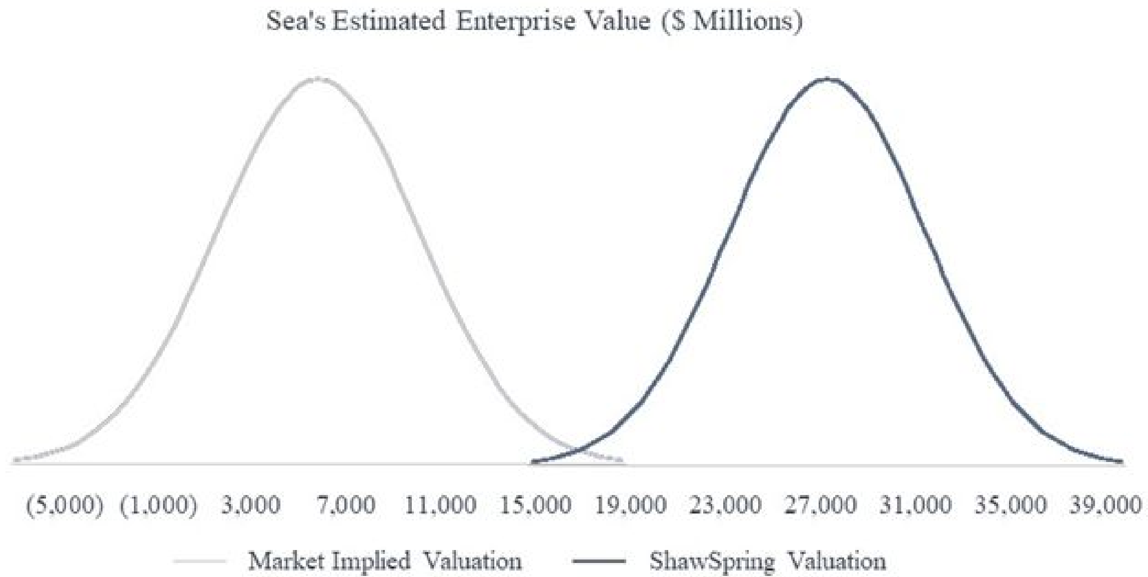
Source: ShawSpring Research

The impact Optionality had on Sea Limited's expected return was even more stark since the market was implying zero value for Shopee, while we estimated it was worth $16 billion in 2019.



Source: ShawSpring Research

When we compared the market's valuation of Sea Limited to our valuation, which included our variant perspectives on Shopee and *Free Fire*, we found that our valuation was roughly 5.6x the market's:



Source: ShawSpring Research

Since Optionality requires a misunderstanding by the market, there tends to be an aspect of nonlinearity once enough facts are made public. Once enough market participants begin to realize the value of Optionality, the narrative around the Business shifts, creating a positive reflexive feedback loop that oftentimes causes a rapid expansion in valuation.

Source: ShawSpring Research. Valuation is based on the average stock price during each quarter.

So why did the market fail to properly value *Free Fire* and Shopee? Similarly, AWS and Tinder are both obvious investments in hindsight, but not before the fact. Why did the market struggle to foresee the value they would create? In a world with perfect information, these businesses would have all been properly valued far earlier—but this was not the case. Why? Part of it comes down to psychology and people's tendency to extrapolate when considering the unknown.

Psychology & Linear Extrapolation

When evaluating the future growth of companies, we notice the market frequently omits Optionality (or other variable factors) in its projections and oftentimes assumes some linearity of growth relative to current rates for the sake of projecting subsequent years' financials. We believe that the human tendency to entirely omit the unknown when considering the future growth of a business, and to base future value on a linear pattern relative to present or past circumstances, oftentimes either over- or under- estimates the true valuation of a company.[14]

One of the roots of this problem lies in investors opting to use linear models of forecasting future growth and earnings.[15] Forecasters for major indices choose to apply linear growth models when considering multi-year growth as well.[16] It seems that when the market is unsure about the future, it applies a simple linear growth rate relative to the market's current circumstances for valuing equities, which imprecisely forecasts the actual trends of future growth.

Nobel Prize laureate economist and psychologist Daniel Kahneman explains that humans have a tendency to subconsciously (and very naturally) over-simplify complex matters, generally by omitting variables that complicate the analysis.[17] When we consider what a business might look like 100 years from now, we naturally simplify the means of approaching the answer because we immediately recognize the analysis to be too complex.[18] This is true when an investor attempts to consider the growth rate trendline for anything past the following year, and this simplification manifests itself in the omission of variables that deviate from past trends.[19]

Even more problematic, people's fear of the unknown makes decision-making, especially when the stakes are high, more irrational and inefficient.[20] Compounding this is the career risk associated with being non-consensus. An analyst may believe a company's growth rate will inflect from 10% to 20%, but the risks associated with making a non-consensus bet if these projections turn out to be incorrect is sometimes unpalatable. This is exacerbated by the fact that many professional investors are accountable to external clients and other capital owners for whom they are in charge of managing money; a linear extrapolation based on historical trends is more defensible to external investors than exponential or other non-linear forms of future growth expectations.

As a result, when investors are confronted with the task of projecting future growth trends beyond the following year, betting large sums of money on their accuracy, they often fold to making simpler projection models that minimize the number of variables necessary to make the assessment, and to minimize scrutiny. The result is typically a bull, base, and bear case, which mirrors what is shown in the following graphic:

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[14] See generally "Gordon Growth Model", the growth valuation model of choice taught by Harvard Business School, which includes a constant growth rate year after year for its valuation.

[15] See generally "Gordon Growth Model", the growth valuation model of choice taught by Harvard Business School, which includes a constant growth rate year after year for its valuation.

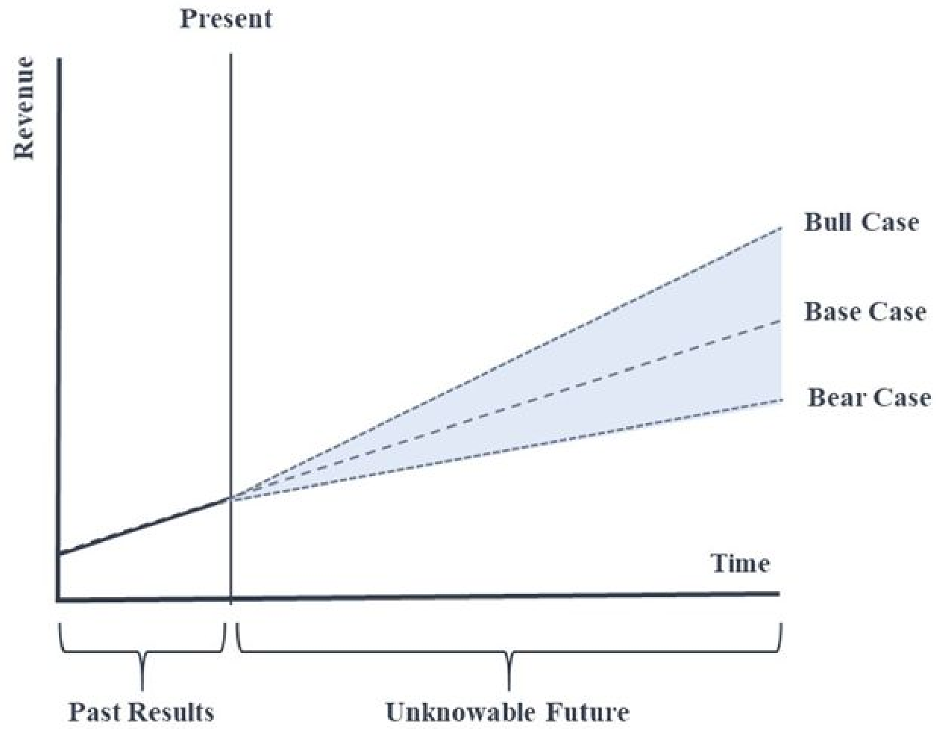
[16] Id.

[17] Kahneman, Daniel. Thinking, Fast and Slow. Farrar, Straus and Giroux, 2015.

[18] Id.

[19] Barrow, Alex. "Underwriting the Future + MU Bull Case." Macro Ops, 19 Oct. 2020, macro-ops.com/underwriting-the-future-mu-bull-case/.

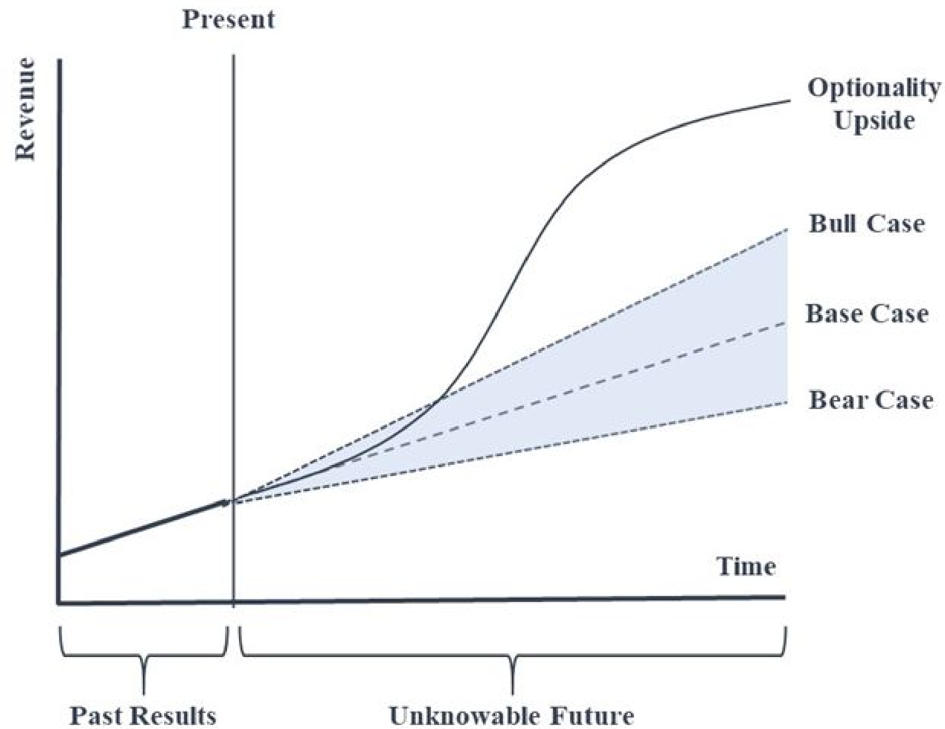
[20] Author links open overlay panel, R. Nicholas Carleton, et al. "Fear of the Unknown: One Fear to Rule Them All?" Journal of Anxiety Disorders, Pergamon, 29 Mar. 2016.



Standard trend growth extrapolation[21]

These forecasts are likely more accurate when considering just the mature business, but they fail to incorporate Optionality.

[21] Barrow, Alex. "Underwriting the Future + MU Bull Case." Macro Ops, 19 Oct. 2020, macro-ops.com/underwriting-the-future-mu-bull-case/. *ShawSpring modified this graphic for this letter.



Standard trend growth extrapolation with Optionality[22]

Importantly, we are not saying that adequate returns cannot be earned from current core business models—they certainly can be. Instead, we are trying to convey that although the market is relatively efficient at valuing core business models, it struggles to value the less knowable.

Putting It All Together

There is still much to say about Optionality: importantly, how we value it and include it as a meaningful metric in our investment analysis. We plan to continue this conversation on Optionality and ShawSpring's investment strategy, with this introductory letter serving as a starting point.

[22] Barrow, Alex. "Underwriting the Future + MU Bull Case." Macro Ops, 19 Oct. 2020, macro-ops.com/underwriting-the-future-mu-bull-case/. ShawSpring modified this graphic for this letter.

Our Portfolio

The Partnership currently holds stakes in eight businesses that offer products and services globally. Our companies engage in a diverse array of business activities including digital payments, digital financial services, home services, online dating, social networking, mobile gaming, cloud computing, digital advertising, takeaway food delivery, and ecommerce.

The Partnership's investments as of October 31, 2020, are accounted for in the table below:

Investment	% of Gross Exposure
Sea Limited (SE)	25%
JD.com, Inc. (HKG: 9618)	15%
IAC/InterActiveCorp (IAC)	13%
Match Group, Inc. (MTCH)	12%
Square, Inc. (SQ)	10%
Mercari, Inc. (TYO: 4385)	10%
Just Eat Takeaway.com N.V. (LON: JET)	6%
ANGI Homeservices Inc. (ANGI)	4%
Cash and cash equivalents	5%
Total	100%

The investments set forth above should not be considered a recommendation to buy or sell any specific securities. There can be no assurance that such investments will remain in the portfolio.

Portfolio Activities

Acquisitions

"Acquiring" Match Group

On June 30th, the Partnership received its *pro rata* shares of Match Group in a distribution transaction from parent company IAC. As many of you are aware, our investment in Match Group commenced in October 2016 when we purchased our stake in IAC. At that time, IAC owned 84% of Match Group, with Match Group accounting for most of IAC's net asset value.

We continue to be excited about our investment in Match Group. Tinder's outlook remains strong, especially as it further penetrates more nascent markets, like Southeast Asia and India, where category penetration is low. Beyond Tinder, Match Group's other brands are becoming material growth drivers for the first time since the company's IPO. For example, emerging brands, which include Hinge and Pairs, grew revenue 88% year-over-year in Q3, resulting in non-Tinder direct revenue growing 23% year-over-year. We expect that Optionality in the form of Match Group's existing portfolio of emerging brands will drive sustained high revenue and free cash flow growth over the coming years.

Dispositions

Selling Carvana

In September, we made the decision to exit our investment in Carvana. Over our two-year holding period, we generated an internal rate of return of 114%. Our exit decision is unrelated to a change in our assessment of Carvana's business quality, long-term opportunity, or management team. Instead, our rationale was based on our internal estimate of Carvana's valuation, and our forecast for prospective returns. We continue to believe in the strength of Carvana's vertically-integrated business model, and the superior customer proposition Carvana provides to used-car buyers. While we have no doubts that Carvana will remain a great business, we believe that at Carvana's current valuation, it makes sense to shift our attention towards other equally fantastic businesses which have long growth runways less appreciated by the market. We will continue to follow the company's progress closely and expect to take advantage of any dislocations that may cause Carvana's expected return to meet our high hurdle rate for re-investment.

Organizational Updates

Over the past four years, we have written to our investors along the quarterly tempo as other funds do—giving our investors updates on current and prospective investments, as well as on our investment strategy. However, our goal through our letters is to share what we are learning with our investors, not to discuss contemporaneous portfolio performance and other perfunctory macroeconomic happenings. As a result, the typical 90-day period between publishing letters feels somewhat less relevant to our Partnership. We believe it makes more sense to publish letters when we have something important to share about the Partnership—for example, portfolio acquisitions or dispositions, or various topics on business theory or investing that we have spent time researching. Going forward, our letter writing cadence will be more variable, depending on what we think our Partners will find interesting and important to learn. Irrespective of these changes, our team is available any time, regardless of our letter writing frequency.

To Our Partners

We consider our investor base a key competitive advantage. As many of you know, we are methodical and deliberate about who we invite into our Partnership. Our strategy would have quite different results if it were not for the patient, steady hands of our current investors – who encourage us, challenge us, and give us the freedom to invest when the inevitable selloffs in the market occur. Cultivating the right Partnership base takes time. Fortunately, we are in this business for the long-term.

We are grateful to our Partners for entrusting us with their capital, and for enabling us to execute a world-class investment research process. We do not take our fiduciary duties and responsibilities lightly.

Moreover, we are proud to invest on behalf of such a prestigious base of investors, comprised of university endowments, charitable foundations, and successful entrepreneurs. We take great pride that our efforts contribute to the important missions of our stakeholders. Thank you very much for your support.

We look forward to writing to you again in the near future. In the meantime, please reach out any time. We would love to hear from you.

With Best Wishes,

The ShawSpring Partners Team

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Prospective investors should be aware that an investment in the Fund is speculative and involves a high degree of risk. There can be no assurance that the Fund's objectives will be achieved or that an investor will receive any return on its investment in the Fund. The Fund's performance may be volatile. An investment should only be considered by persons who can afford a loss of their entire investment. The Fund expects to invest substantially in equity securities. The value of these securities generally will vary with the performance of the issuer and movements in the equity markets. In the event of the death, disability or departure of any of principals or other key members, the business and the performance of the Fund may be adversely affected. There is no organized secondary market for investors' interests in the Fund, and none is expected to develop.