Portfolio Strategy

Arch Capital Q1 2022 Investor Letter

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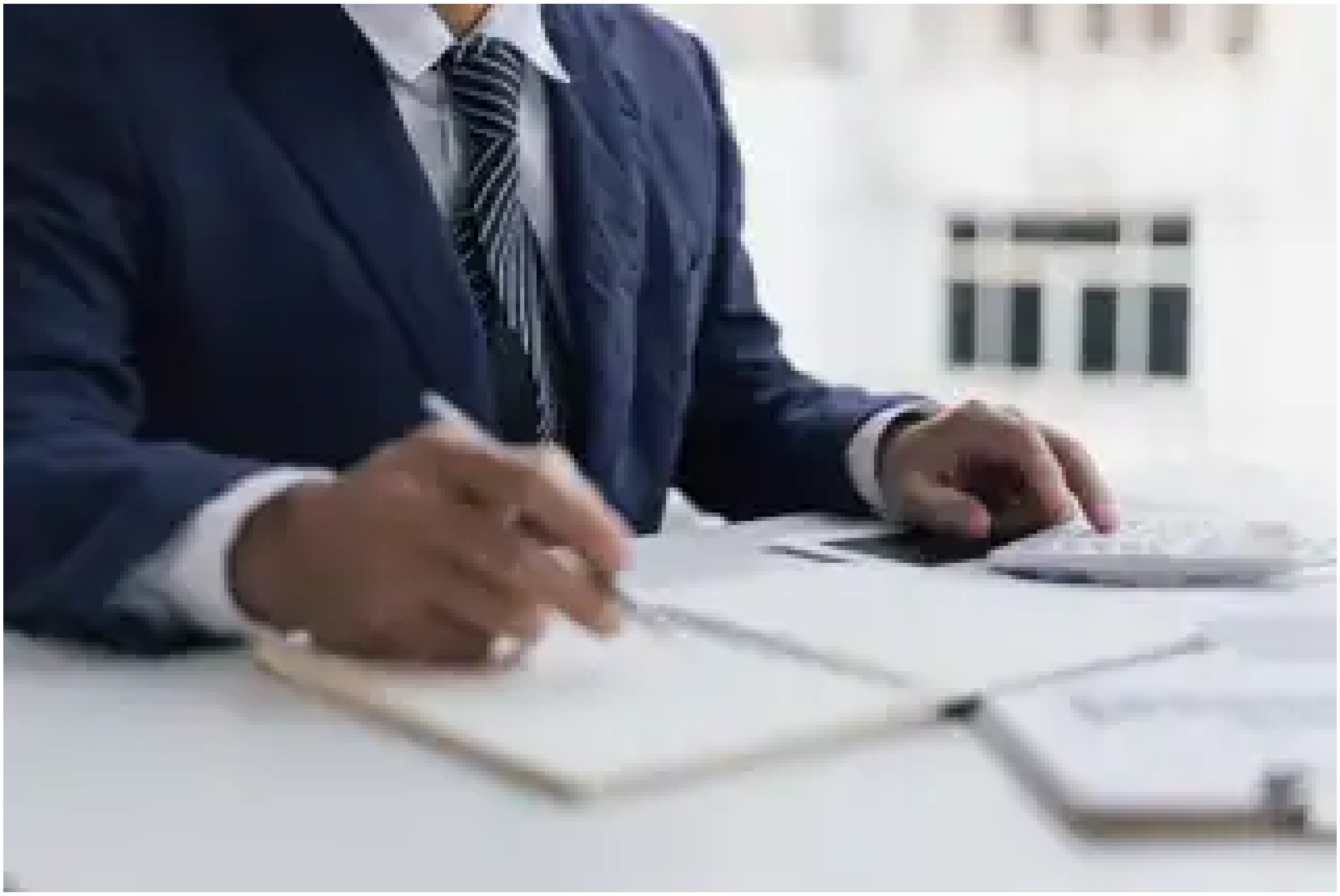
Summary

- Arch Capital is a concentrated, long-only equity fund aiming to compound capital at an above-market rate.
- The fund holds a concentrated collection of high-quality businesses purchased at prices where we believe forward returns can exceed a rate of 15% a year.
- With the fund down 15.3% since inception, the market does not agree with our assessments.



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	Arch Capital Investors Fund	S&P500TotalReturn Index
Returns Year To Date	(12.2%)	(4.6%)
Returns Since Inception (2/1/21)	(15.3%)	24.1%

**Fund returns are as of the end of Q1 2022 and net of realized and estimated fees. Returns may differ based on the timing of entry into the limited partnership.*

Dear Limited Partners,

As year two of the partnership gets underway, we remain incredibly optimistic about our long-term prospects. The fund holds a concentrated collection of high-quality businesses purchased at prices where we believe forward returns can exceed a rate of 15% a year.

However, so far, with the fund down 15.3% since inception, the market does not agree with our assessments. The negative performance can be attributed to two stocks in the portfolio, **Wix (WIX)** and **Spotify (SPOT)**, which have a negative contribution to fund returns of 5.39% and 9.19%, respectively, as of this writing. Take those stocks out and fund returns would be positive since inception.

This isn't to make an excuse for the fund's poor returns. We made the choice to buy Wix and Spotify in 2021, and so far the market has punished us for it. But that is in the past. All that we can do right now is evaluate potential investments and our confidence in whether they can produce *forward returns* of 15% or more.

Below, we outline why both Spotify and Wix still fit this criterion and therefore remain core holdings in the fund.

Spotify

Our reasoning for investing in Spotify had three fundamental tenets:

1. Music streaming subscriptions are a durable industry that will have better unit economics over the next five years than the previous five.
2. The company is evolving beyond music to become a global audio platform. In the near term, this will play out through podcast advertising, and over the long term, it opens up tons of optionality for new business models.
3. The market has not priced in what this will mean for the business over the next three to five years. We believed this was true when the stock was close to $300 a share, and even more so when it is below $150 a share.

It has only been around a year since our initial purchases of the stock, but so far, parts 1 and 2 of our thesis are proving correct. In 2021, here's how the premium music business evolved:

- Subscribers grew 16% year over year to 180 million.
- Average revenue per user (ARPU) grew 3% year-over-year in Q4. This occurred because Spotify raised prices in a few key markets. It should be noted that customer churn was stable even with the price increases, according to CFO Paul Vogel on the latest conference call (although they never give out specific numbers).
- Premium gross margin was 29.2% in Q4 2021, up from 28.9% in Q4 2020 and 27.3% in Q4 2018. We expect this positive trend to continue over the next five years.

Spotify made a ton of progress on its journey toward a global audio platform in 2021. The most important product launched was the Spotify Audience Network (SPAN), a dynamic marketplace where advertisers can easily place audio ads across music and podcasts. SPAN is key because it will allow Spotify to turn its advertising business into something more akin to YouTube and less like analog radio. The key to this is opening up ad inventory across its distribution platforms Anchor and Megaphone in conjunction with making ads more targeted and dynamic (which just means inserted digitally instead of host-read ads). This makes life better for advertisers with a much simpler selling process, podcasters with a much simpler way to make money, and Spotify as it takes a cut of every ad dollar.

It is still very early days for SPAN, but so far things look to be going quite well. Advertising revenue grew 40% year-over-year in Q4 2021, and executives have highlighted numerous times that podcasting revenue is growing much faster than the overall number. We expect this rapid top-line growth to continue over the next five years as Spotify slowly expands SPAN around the globe.

As of this writing, Spotify has a market cap of ~$27 billion. By 2026, we expect the business to generate around $8.5 billion in annual gross profit if it continues to execute growing its premium music business and SPAN. Assigning a price-to-gross profit (P/GP) of 10 on the business – which is reasonable if you believe Spotify can convert around half of its gross profit to free cash flow at maturity – its market cap will be $85 billion five years from now. That is a compound annual growth rate (CAGR)of 26%. Assume some modest share dilution from now until the end of 2026, and our expected forward returns should be somewhere in the neighborhood of 22% - 24% over the next five years. This comfortably exceeds our 15% hurdle rate.

Wix

Wix is a global website building company based in Israel that's valued at $4.6 billion today. Put simply, Wix's intuitive, drag-and-drop platform allows anyone to build and manage their own custom website without needing to write a single line of code. Though Wix has also developed some promising professional tools, its flagship DIY platform still comprises the majority of revenue, so that's where we'll focus.

A bit of background:

Prior to Wix, many small businesses lacked the digital expertise or know-how to establish an internet presence. While there were some available solutions like Wordpress and other open-source platforms, the complexity and required security maintenance often forced small businesses to consult the help of external website design firms instead. However, with Wix, there's no longer the need (for most businesses). Between Wix's ease of use, professional-looking designs, and holistic suite of operational tools, small businesses now have everything they need to build and maintain their digital presence on their own.

Wix's approach has certainly been well adopted in recent years as is evident by its rapidly increasing market share. Today, Wix is home to more than 6 million premium subscriptions (paying users), and the company powers an estimated 3.4% of all websites that use a content management system – versus just 0.6% five years ago.

Current situation:

While this core 'build and subscribe' business has proven to be quite profitable in the past, Wix has opted to spend the last several years reinvesting its excess cash back into the business instead of maximizing for profits. These investments appear to be focused in three areas.

1. **Expanding Business Solutions:** Starting in the fourth quarter of 2019, Wix began segmenting its revenue into two separate line items – Creative Subscriptions and Business Solutions. Business Solutions refers to any product or service that is offered to users beyond their premium subscription. These include some vertical-specific tools like bookings for hotels and inventory management for merchants, but the majority of the business comes from Wix Payments. Wix has not only spent hundreds of millions of dollars developing these solutions in-house, but it has also acquired several applications in the last year alone as it tries to expand its offering.

2. **Building EditorX:** Unlike Wix's core Editor platform which was designed for individuals, EditorX is purpose-built for agencies or freelancers with multiple clients. Wix launched this service in February of 2020 and has since allocated plenty of resources to help it grow. Though this segment is still relatively small (accounts for ~20% of overall revenue), it has nearly tripled in size over the last two years and Wix's CEO stated that he thinks the market is 10x larger than the self-creator space. While there appears to be plenty of upside here, we don't think investors are paying much for it today. But more on that later.

3. **Marketing/Customer Support:** A premium subscription is worth a lot for Wix and management knows that. Switching to a new content management system and completely rebuilding a website is a tall task for most small businesses and simply not worth the effort as long as the current solution gets the job done. Since this means customers are likely to stick around once they're locked in, Wix is willing to pay up for customer acquisition. And that's exactly what they've done. Over the last two years, Wix significantly increased its spending on both marketing and customer support in an attempt to onboard new subscribers.

While we think all of these investments should serve Wix well in the long run, for the time being, they're masking the profitability of the overall business and forcing many investors to raise questions about the viability of Wix's entire business model. In turn, the stock has sold off by more than 60% over the last year – as we know all too well.

But this short-term blip in profitability is not deterring us from Wix as an investment. In fact, quite the opposite. Wix has become a core holding in the fund, as it now looks far more likely that Wix will surpass our 15% annual return threshold. Here are our assumptions for the next five years that help us get there:

- **Premium subscriptions grow by 10% per year** – Has compounded at 19% over the last 6 years.
- **Price per subscription grows by 6% per year** – Has compounded at ~6.5% over the last 4 years
- **Business Solutions Revenue per subscriber grows by 10% per year** – Has compounded at ~40% over the last 4 years but growth should slow coming out of covid as more transactions move offline and the segment matures.
- **Free cash flow margins reach 17% by 2026** – Have achieved free cash flow margins of 17% in the past and on the latest conference call management telegraphed margins to return to that point over the long-term.

If Wix hits or beats these conservative assumptions, it will generate more than $400 million in free cash flow in 2026. At a valuation analogous to the market average, that results in 15%+ annual returns for our investors.

For further discussion about our portfolio or anything related to your investment, please don't hesitate to reach out.

Sincerely,

Brett, Brady, and Ryan.

Original Post

Editor's Note: The summary bullets for this article were chosen by Seeking Alpha editors.

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