February 7, 2024

Asheville Capital Annual Letter

Dear Partners,

The Asheville Capital portfolio produced a net return of 23.4% in 2023. This compares with the MSCI ACWI, our benchmark, which produced a 22.3% return. Asheville Capital has been in existence for 20 months now and has produced a cumulative return of 16.5%.

Performance Statistics [1]		
	Asheville Capital	**MSCI ACWI**
2022	-5.6%	-2.6%
2023	23.4%	22.3%
Cumulative Return	16.5%	19.1%
Annualized Return	9.4%	10.8%

[1] Past performance is not indicative of future results. All return figures represent the aggregate returns, net of fees, of all seperately managed accounts managed by Asheville Capital Management

I am pleased with our results in 2023 while at the same time aware of the fact that the signal-to-noise ratio is extremely low in any twelve-month period. Very little has changed over the course of the last twelve months in regard to the intrinsic values of our businesses. Each of them have grown a little bit larger, gained a little bit more market share, and, in most cases, have become more profitable. There have, however, been great swings in the *perceived* value of our businesses during this past year.

For example, **Temple & Webster's** multiple of gross profits declined to a low of 2.4x in mid-March and closed the year at 7.6x. Yet, gross profits did not evaporate by 80% during the year while the stock price stayed flat. Rather, gross profits declined by 5% while the market-assigned value of those gross profits rose by more than 200%. In another example, consider **Elastic**, which opened 2023 at 6.5x gross profits and closed it at 12.7x, a 95% increase despite a mere 20% increase in actual gross profits. Or rather, consider an inverse outcome in which multiples of **Basic-Fit**, a new entrant to the Asheville Capital portfolio, declined in value over the course 2023 from a high of 9.1x gross profits to 5.5x despite growing actual gross profits by 55%.

In each of these examples, the vast majority of the change in share value was the product of changes in perceived value rather than by changes in the actual values themselves. More specifically, multiples are a proxy of future expectations. *Therefore it could be said that the market implied expectations of future values were the primary determinants of stock price performance in 2023.*

I know that you understand these things already, but please walk down this elementary road with me a little bit further. If you recall, I dedicated the entirety of our 2023 Interim Letter writing to you about

Temple & Webster, an Australian furniture e-commerce marketplace and retailer that we have allocated a large proportion of our assets to. In February, Temple & Webster's shares declined by 26% in a single day on the back of what was perceived to be a negative earnings report. I wrote to you that Temple & Webster's challenges were transient in nature and that, if you were to dig into the publicly available industry data, it was actually quite clear that Temple & Webster was consolidating market share. Therefore I deemed it likely that Temple & Webster would return to growth in the near future, given that Temple & Webster's long-term tailwind (i.e. underpenetration in Australian furniture e-commerce) and competitive advantage (as the scaled marketplace with a dominant mind-share) was unimpaired.

Only a few months later, in November, the furniture industry remains negative on an annual sales basis, yet Temple & Webster has returned to growth in resounding fashion. First half sales have risen by 26% year-over-year, with Q2 revenues, in particular, growing by 42%. The question of if and when Temple & Webster might return to growth has been answered and the *future expectations* for revenues and earnings have adjusted accordingly. In other words, the multiple expanded.

It is the opinion of your portfolio manager that while markets are generally good at pricing in current quantitative data, they are rarely good at predicting subsequent performance. This is especially true the longer that you expand your time horizon. In any twelve month period going forward, we are likely to experience severe bouts of volatility. The concentrated nature of this portfolio, combined with the fact that we invest exclusively in the ugly ducklings of today's quantitative data, makes it such that we will experience volatility at a greater rate than that of public equity indices, which are themselves an already volatile asset class.

However, I humbly submit to you that if I have done my job; that is, if I have executed our strategy to invest in **world-class businesses before they are broadly appreciated as such**, then we can look to the future with confidence, knowing that our ducklings today will soon be shedding their black feathers and *producing quantitative data in the form of increased earnings per share and returns on capital that put them in the top tier of the public equity universe.*

You might ask therefore; how long must we expand our time horizon by? If twelve-month returns are primarily the product of multiple expansion/contraction, then what period of time is sufficient for earnings growth to become the primary driver of returns? At what point do these ducklings shed their plumage? While I invest in each of our businesses with an eye towards a decade-plus long holding period, I also believe that a three-year period is, in most cases, a sufficient time to determine if we do, in fact, own future swans. In three years of ownership, our world-class businesses should be at various stages of revealing themselves. *Said another way, in a three-year window, returns on incremental capital should be driving returns on total capital higher, thereby increasing earnings per share, and contributing to the majority of the growth in share value.*

In June, an important study on this topic was published by Michael Mauboussin and Dan Callahan titled *ROIC and the Investment Process*. It examined the link between shareholder returns and ***changes*** in returns on invested capital (ROIC). In effect, what happens to share value when a company's ROIC changes? See the below data table that looks at total shareholder return (TSR) over a three year period based on changes in ROIC quintiles.

Exhibit 9: Annual 3-Year TSRs for Combinations of Beginning and Ending Quintiles, 1990-2022

		Ending Quintile				
		(Best) 5	4	3	2	(Worst) 1
Beginning Quintile	(Best) 5	20%	7%	0%	-4%	-11%
	4	25%	14%	6%	0%	-10%
	3	28%	18%	10%	2%	-6%
	2	28%	20%	14%	6%	-5%
	(Worst) 1	33%	23%	15%	8%	-3%

Source: FactSet and Counterpoint Global.
Note: Excludes financials and real estate; Past performance is no guarantee of future results.

If, for example, a company begins a three-year period as a top-tier producer of ROIC (meaning 5th quintile; a group that averaged 29% ROICs in 2019), and during the course of those three years, it were to slip only one-rung lower to the second-best tier (the 4th quintile), its returns to shareholders would have been a relatively miniscule 7% per year. Alternatively, if a company were to begin a period in the second-worst tier (the 2nd quintile) and were to improve its ROICs over a three-year period to grow into the second-best tier (the 4th quintile), its returns to shareholders would have been 20% per year on average, or a 72% cumulative return over three years. [1]

As Mauboussin and Callahan write, *"The results show what common sense suggests: Rising ROICs tend to be good for shareholders and falling ROICs tend to be bad."* But what was most notable, in my opinion, was the next data table, which examined the transition rate of companies from one-tier to the other.

Exhibit 10: Transition Rate from Beginning to Ending Quintiles, 1990-2022

		Ending Quintile				
		(Best) 5	4	3	2	(Worst) 1
Beginning Quintile	(Best) 5	48%	19%	11%	8%	15%
	4	22%	31%	21%	14%	12%
	3	11%	23%	29%	23%	13%
	2	8%	15%	25%	33%	19%
	(Worst) 1	12%	11%	14%	22%	41%

Source: FactSet and Counterpoint Global.
Note: Excludes financials and real estate; Past performance is no guarantee of future results.

Over the last 32 years of concurrent three-year periods, a surprising 52% of companies who began a period in the top quintile transitioned to a lower quintile *in only three years*. This should serve as a shot across

[1] Companies in the 5th (best) quintile have consistently produced ROICs between 20-35% over the last 32 years from 1990-2022. Companies in the 4th quintile have produced ROICs in the 12-15% range. Companies in the 3rd (middle) quintile, which comprises the largest *n* of companies under the bell-curve, have produced ROICs between 8-11% in each of the last 32 years. Companies in the 2nd quintile have done 0-7% and companies in the 1st (worst) quintile have produced negative ROICs in all but three of the last 32 years. For more information on this particular data please see *ROIC and the Investment Process, Exhibit 4*.

the bow to anybody who makes it a habit of being long-term investors in companies with historical returns on capital as a central theme of their investment theses.

If, however, ***we make it a habit of investing in companies with low returns on historically invested cumulative capital, but which are sustainably producing top-tier returns on incremental capital***, ***then the simple math equates to returns on total capital improving with each passing year, to the benefit of our shareholdings.*** Ugly ducklings to swans. Low-ROIC producers to high-ROIC producers. It is a beautiful way of describing my reason for investing in world class businesses before they are broadly appreciated as such.

Portfolio Update

During 2023 we made four trades. The first of these was the aforementioned **Temple & Webster** trade; when we significantly increased the size of our investment at a time when its valuation was suffering from a short-term bout of insanity. The latter three trades were the substitutions of three of our US-based technology holdings (**HashiCorp**, **Confluent**, and **Magnite**) for three new holdings in European fitness centers (**Basic-Fit**), European logistics (**InPost**), and Japanese healthcare technology (**Medley**). As of year-end, we still own nine global public equity positions, but the net result is a more diversified basket with a significantly higher expected return threshold. Going into 2024 each of our nine positions are more or less equally weighted, with Temple & Webster, Basic-Fit and Medley being the only three with noticeably larger sizings.

If we had have simply held our holdings that we began the year with and made no trades throughout the year, our returns would have been 9.2%, a paltry result relative to our actual output of 23.4%. Effectively all of the difference between this and our actual output stems from our decision regarding Temple & Webster, which contributed 14.1% to total returns. Other significant contributors to returns in 2023 included **Elastic** (+5.4%) and **Acast** (+3.4%) while **Raksul** (-6.4%) and **Agora** (-4.1%) were our primary detractors.

While I would love to see a more even split of contributions across our entire portfolio, it is somewhat comforting to know that we were able to generate decent returns despite the majority of our holdings becoming noticeably cheaper throughout the year. Apart from Temple & Webster and Elastic, the rest of the portfolio appreciated in share value only minimally. However, these businesses continued to chug upwards in gaining revenue, market share and earnings power at a rate that has far surpassed that of their share values. Therefore, I believe it is reasonable to be both pleased with the previous year's results and at the same time humbly confident in the future expected returns of the combined portfolio.

If my research is based in reality then we may be reasonably assured that our businesses will continue to produce returns on incremental capital that are in excess of their market-implied expectations. Let us therefore focus not on the number of decisions being made, but on the decision making process itself and in the quality of those decisions to produce outsized returns at minimal risk.

Basic-Fit

During the second-half of the year I wrote to you detailing our investment theses for InPost and Medley. I would now like to briefly describe our reasons for owning Basic-Fit as well.

Basic-Fit is an operator of fitness centers in Europe. With 1,402 clubs and 3.8 million memberships across six countries, Basic-Fit is the largest fitness chain in Europe.

Given Asheville Capital's mandate to invest in world-class businesses before they are broadly appreciated as such, let me clearly state the following: *Basic-Fit is world-class due to the fact that it produces a compelling value proposition that is both competitively advantaged and capital efficient, thereby resulting in returns on incremental capital that are both high and sustainable. Basic-Fit is not broadly appreciated as such due to the fact that these returns on incremental capital are currently hidden underneath a reinvestment cycle that takes time to materialize.* As these earnings reveal themselves, it seems likely for the future valuation to reflect the cash flows of the individual units more accurately.

Overview

Fitness centers themselves are a phenomena that was birthed out of the United States in the 1980s. Their popularity coincided with a general incline in obesity rates and diabetes. These diseases are continuing to claim more victims internationally, and so too is there a growing awareness for the need to exercise. In countries like France, Belgium, and Spain, gym membership as a percentage of the total population is approximately half that of the United States. Basic-Fit operates in these countries as the low-cost fitness option. At €24.99 per four weeks, people gain access to the highest value-for-dollar fitness center that is to be found in all of Europe.

Basic-Fit offers conveniently located, low-cost access to high quality fitness centers. Basic-Fit has cut out expensive, underutilized amenities like swimming pools and basketball courts in exchange for more treadmills, weight machines and free weight areas. The result is a greater capacity for high-utilization equipment at a lower total cost to the fitness center owner. Basic-Fit therefore maximizes its revenue per club while minimizing its costs. These cost savings are further optimized when you account for the scale that Basic-Fit operates with. By being the largest fitness chain in Europe, Basic-Fit enjoys bargaining power with its suppliers that allows the company to negotiate lower equipment purchase prices. These collective cost savings are passed on to the consumer in the form of lower prices. This engenders mass appeal to the majority of local populations and high rates of loyalty, resulting in maximal return on ad-spend and best-in-class churn rates.

Basic-Fit is very similar to its US-based comparable, Planet Fitness. Both operate low-cost fitness center models. But Basic-Fit and Planet Fitness differ in one key area; that of franchising. In the United States, Planet Fitness has opted to franchise its brand out in order to reduce its total capex requirement. This has allowed Planet Fitness to grow quickly with reduced capital expenditures per unit and it has created a lucrative revenue stream of equipment resale to its captive franchisee customer base. But in doing so, Planet Fitness has also ceded control of location decision-making. Basic-Fit's CEO, René Moos, rejected this model under the reasoning that greater control of club location will result in a more defensible membership revenue stream. In owning each of its locations, Basic-Fit is able to execute a cluster strategy in which clubs are built with significant geographical overlap to its other fitness centers.

Source: Basic Fit Investor Presentation

This is a decision that franchisees would never opt into of their own volition due to the cannibalization of its base of potential members. Basic-Fit reasons that this cannibalization is offset by having more convenient locations, and that this benefits its members, thereby making them less likely to churn. Additionally, there are operational and marketing efficiencies to be gained by following this approach. Basic-Fit, when it enters a city, will often times build and launch multiple locations at the same time, thereby ensuring that its local advertisements are relevant to a maximal percentage of the local population. Moreover, by being close together, these clubs can be operated with fewer managerial staff, thus reducing operational overhead. Finally, this cluster strategy serves to both capture market share from existing competitors and deter future potential competitors from entering a market that Basic-Fit has already staked its claim on. When Basic-Fit enters a city that has a low membership penetration rate, it ends up capturing the vast majority of the incremental fitness memberships.

Unit Economics/Valuation

It costs Basic-Fit approximately €1.2 million to build out a 1,500 square foot club. After months of pre-selling memberships, these clubs are cash-flow break-even on day one. In about 24 months, these clubs will have reached a state of maturity at approximately 3,300 members per club. When clubs reach maturity, they generate approximately €870k of revenue per year and cost €439k to operate, resulting in EBTIDA per club of €431k per year for a 50% EBITDA margin and a 36% ROIC.

This gets to my earlier point about Basic-Fit's earnings power being hidden beneath a reinvestment cycle that takes time to materialize. Of Basic-Fit's 1,402 clubs, approximately 900 of them are considered mature, with the other 500 still being immature and within that 24-month post-launch time period. In two years' time, all of these 500 clubs will have reached maturity and the collective 1,402 clubs will be producing more than €1.2 billion of revenue and €600 million of EBITDA. At a market capitalization of €1.9

billion today, these 1,402 clubs are currently being valued at €1.3 million, or 3x 2025 Club EBITDA. There is debt on the balance sheet, however, and Basic-Fit's enterprise value is at approximately €4 billion today, meaning that EV/EBITDA amounts to €2.8 million per club, or 6.6x 2025 Club EBITDA. This does not factor in any of the incremental ~400 clubs that Basic-Fit will likely open over the next two years. These incremental clubs could effectively be considered free.

Another way to look at it is this: In 2023, Basic-Fit is likely to produce more than €1 billion in revenues and more than €500 million in cash flows from operations. Nearly all of these cash flows have historically been spent on growth capex into new club buildouts or on the repayment of debt. In the years to come, Basic-Fit's immature club base will reach maturity and the company's embedded earnings power will reveal itself through the growth of operating cash flows in a non-linear manner. Similarly, growth capex and debt repayment will make up incrementally smaller proportions of operating cash flows, thereby producing a dual tailwind effect in which operating cash flows are expanding at approximately the same time that uses of cash flow are decreasing proportionately.

If we were to ignore growth capex in an attempt to assess the stand-still value of Basic-Fit today we would deduct approximately €80 million in ongoing maintenance capex from the estimated €500 million of operating cash flows to arrive at €420 million of stand-still free cash flow. With 66 million shares outstanding, this equates to €6.36 of stand-still free cash flow per share. At year-end, Basic-Fit's shares traded at €28.16, meaning that Basic-Fit trades today at 4.4x stand-still free cash flows. If you were to take into consideration total enterprise value, then the math would equate to ~10x stand-still free cash flows. Basic-Fit is therefore cheap on an absolute basis.

All of this would be for naught, however, if Basic-Fit were unable to maintain its unit economics. To that end, we turn to Basic-Fit's staying power not just as an operative business but as a high-caliber producer of returns on incremental capital that should see them grow into the highest quintile of the public equity universe (and hope to stay there). At the most basic level, fitness membership is a long-term trend that is unlikely to go away anytime soon. The nearest existential threat that we have witnessed to this industry unfolded just a few years ago, when the coronavirus pandemic shuttered everyone indoors for extended periods of time. Basic-Fit lost 34% of its revenue from 2019 through 2021. The company swung very quickly from producing small profits to deep losses and had to issue equity to meet its debt obligations and to continue to keep its head above water. Importantly, René Moos and his team saw this for what it was… a transient headwind, and he continued to invest in new store buildouts during this time period to position Basic-Fit to capture market share at a time when its competitors were at their weakest. Having made it through to the other side, Basic-Fit is a stronger business today, with a significantly larger presence and the company has since regained all of its lost revenue. When Basic-Fit reports its 2023 revenues in a few days it will have nearly doubled its revenues from its pre-pandemic high-point and more than doubled its operating cash flows. The company maintains a 2.6x leverage ratio with limited debt repayments required over the next three years and is well positioned to continue to roll out around 200 clubs per year.

From a competitive standpoint, Basic-Fit has made it incredibly difficult for low-cost gyms to successfully compete with them. Its cluster strategy has gained Basic-Fit the lion's share of memberships within its existing locales and it continues to take market share in the regions that it is expanding into. Over the last year, I have spoken with more than a dozen employees of competitor fitness clubs in Europe and the general perspective is that Basic-Fit is an unstoppable force in Europe. When Basic-Fit announced its entry

into Spain a few years ago, a number of Spanish fitness chains offered their clubs for sale, with one purchase actually going through in December of this year when Basic-Fit acquired the 47 locations of RSG Group at a purchase price that I estimate to be below Basic-Fit's total build cost. Apart from low-cost competitors, boutique gyms and niche services like Cross-Fit and cycle clubs stand to compete only on the fringes and do not have the mass appeal that Basic-Fit offers to the general public.

There are uncertainties, to be sure. There are questions of whether Basic-Fit is going to be able to maintain its ultra-low overhead costs. Questions about if Basic-Fit can keep its maintenance capex at their guided-for levels. Additionally, Basic-Fit is expanding into Germany which is significantly more complex than its previous markets with a competent, albeit smaller, competitor already established. Nevertheless, Basic-Fit operates with a highly stable stream of revenues and a value proposition that appears to transcend geographical boundaries. It maintains a traditional moat around its business and is passing through its economies of scale to its customers in an effort to maintain its position as the highest value-for-dollar fitness chain despite inevitable increases in unavoidable fixed expenses. As Basic-Fit gains scale and regional market share it becomes increasingly difficult for new and existing fitness operators to compete with them. The best opportunity for a competitor was a decade ago, and now it seems as if the opportunity has passed the industry by.

Lastly, and perhaps most importantly for Basic-Fit's immediate future, René Moos, Basic-Fit's Founder and CEO remains at the helm and aligned with shareholders, with 9% of the shares outstanding. In future years, as Basic-Fit, the company, reaches maturity, this likely becomes a business that an idiot could run.

Portfolio-Level Summary

In conclusion, I remain convicted that we own a basket of world-class businesses that are not broadly appreciated as such. In the early days of January 2024 I have sold our position in Elastic to initiate a new holding in **Bleach, Inc.** a Japanese marketing business that I will be writing to you about shortly. In the coming months you can expect to receive from me this new investment thesis as well as our Interim Letter.

Although I love talking about our businesses, I restrain myself from writing to you too frequently on the basis that I deeply value your time and attention. I consider it my chief aim in this professional life to faithfully manage the assets that you have entrusted to me. Words do not do justice in describing the depth of gratitude that I feel for your continued trust in me as your portfolio manager. I look forward to the many years ahead of us as we compound our assets together.

Sincerely,

Jake Barfield