7/27/2023

Asheville Capital Interim Letter – 2023

Dear Partners,

Through the first half of 2023 the Asheville Capital portfolio returned 8.0% net of fees. Cumulatively, through our first fifteen months of operation, the portfolio is only slightly above break-even, at 1.9%.

Performance Statistics		
	Asheville Capital	**ACWI**
2022	-5.6%	-2.6%
2023, YTD	8.0%	14.2%
Cumulative TWR (net)	1.9%	11.2%

It is inevitable (but never enjoyable) that we will underperform our benchmark for intermittent periods. The concentrated nature of the Asheville Capital portfolio automatically increases our susceptibility to market fluctuations, particularly in some of the high-growth businesses that we own.

Our confidence in our ability to produce attractive returns does not wax and wane with the short-term vicissitudes of the stock market. But rather, it stems from the diligent execution of our strategy **to invest in world-class businesses before they are broadly appreciated as such**, and from the continued execution of our underlying holding companies.

For example, the happiest moment of the year that we have experienced (so far) came at a time when most would not be celebrating. Shares in one of our positions declined by 26% in a single day on the back of what was perceived to be a negative earnings report. Yet, we were pleased with the numbers in the report and overjoyed at the opportunity to slash our cost basis in this world-class business that is so evidently not appreciated as such.

The company that I am referring to is **Temple & Webster (TPW)**. They operate as an online retailer of furniture and homewares in Australia. Temple & Webster is effectively the Wayfair of Australia, except with a fundamentally superior business model. [1]

Temple & Webster's investment thesis is simple – they operate with meaningful competitive advantages in an industry that is both underpenetrated and minimally competitive. For this reason, they continue to take market share and grow faster than the overall industry with extremely profitable unit economics that put them in the top-percentile of their e-commerce peer group.

It costs Temple & Webster approximately A$69 to acquire a new customer, and the average post-delivery profit that the company earns per customer per year is A$142. This results in a twelve-month return on investment of 205%. The only other e-commerce marketplace that I have encountered with better unit economics than this is **Raksul (4384)**. [2]

[1] In 2015 Temple & Webster acquired Wayfair's operations in Australia and consolidated market share among the very few e-commerce marketplaces that were operating in the country at the time.

[2] See our 2022 Annual Letter to Partners for a brief analysis on Raksul's unit economics and investment thesis.

The reason why Temple & Webster is able to produce such attractive unit economics is primarily because of the dearth of competition that exists in the country and the advantages that TPW has carved out for itself. Many of TPW's competitors are old-school brick and mortar retailers who have been paying a dividend for 15+ years and who are counter incentivized to upend their business model to compete against online marketplaces.

Likewise, Temple & Webster has meaningful barriers to scale that keeps the competition at bay. Temple & Webster enjoys a top-of-mind status within its addressable customer base which leads to higher order frequencies and larger basket sizes relative to its competitors. For example, there is a company in Australia that has been attempting to compete with Temple & Webster since 2015. Despite diligent efforts by this competitor to achieve scale in the market, they are still in a tough position with minimal market share and pitiful unit economics. This company's average per customer ***lifetime*** order frequency is a paltry 1.1x (relative to 2-4x ***per year*** for Temple & Webster), meaning that they are therefore stuck on a hamster wheel of customer acquisition activities with little hope of ever generating the profitable unit economics and sustainable growth that Temple & Webster currently enjoys.

In addition to this advantaged position, Temple & Webster has demonstrated exceptional capital allocation discipline. Temple & Webster's management team refuses to follow their peer, Wayfair, into building a proprietary back-end logistics infrastructure. They view this investment as a costly endeavor that is unlikely to yield a meaningful source of competitive advantage and their preference is to allocate those dollars towards revenue-generative channels that are likely to yield a higher return. Given this difference in capital allocation decision making, it should be no surprise to learn that approximately 75% of Temple & Webster's revenues are delivered via drop-ship. This allows Temple & Webster to shift the inventory risk and delivery expenses over to its suppliers. It also enables a negative working capital model that yields a cash add-back to Temple & Webster's bottom line each year. The other 25% of revenues come from items that are sold under Temple & Webster's private labels. Temple & Webster has exclusive access to sales data, and they leverage this data to own and directly sell several of the top-selling items on the site. This allows Temple & Webster to capture a higher gross margin on these items while incurring minimal inventory risk and maximizing inventory turns. Despite accounting for 25% of total sales, these private label items make up less than 1% of the total available inventory that is listed on the site.

The confluence of these advantages and the astute capital allocation decisions by Temple & Webster's management team has allowed them to produce significantly higher gross margins than Wayfair (46% vs. 28%) and much shorter payback rates despite having lower bargaining power with suppliers, while also remaining debt-free and asset-light.

The aforementioned earnings report that sent Temple & Webster's share price down 26% in a single day revealed a 12% decline in year-over-year sales. In a truly efficient market this would have been accounted for in TPW's share price given that the management team had already foreshadowed this slowdown, as well as the fact that online discretionary purchase behavior is a trackable data point published monthly by the Australia Bureau of Statistics. Nevertheless, we were positively surprised that the 12% dip in revenues was not lower, given that Australian online discretionary purchases were down 20% year-over-year during the same time period, and that TPW grew at a faster pace than the overall market in the prior year's period (+46%). This slowdown was an inevitability given that the most recent earnings period (July-December 2022) came during the midst of an economic reopening from COVID-19 lockdowns.

We found further reasons for optimism in the report because, despite the revenue decline, the important metrics to the above investment thesis remained intact. Profit margins expanded slightly, twelve-month returns on incremental capital remained in excess of 200%, and repeat customers grew to 57% of total active customers, its highest level yet.

Temple & Webster is currently holding its profit margins in the 3-5% range while they intentionally invest into adjacent business lines that have (so far) demonstrated similar, if not better, unit economics than their core marketplace business. Despite the ongoing investment, they anticipate gaining substantial leverage on marketing expenses and cost of goods sold in the coming years and believe that a 15% operating margin is achievable. I share this belief, but the current share price provides sufficient margin of safety in the event that they fail to reach these goals.

The furniture industry remains underpenetrated (~15% vs. the US and UK which are ~30% penetrated) and Temple & Webster is the market share leader (17%). A 1pp increase in both online penetration rates and in TPW market share annually for the next five years yields an 11% revenue growth rate and A$704 million of revenues in 2027. Operating profits approximate free cash flows, given the negative working capital nature of the business model. If margins during that time were to expand from 4% to 10% (5pp shy of their target) then operating profits/cash flows are ~A$70 million. A 20x multiple of these earnings yields a market value of A$1.4 billion, which is a 202% price appreciation (15% annual rate) from today's value. It is worth noting that these estimates predict an industry that remains underpenetrated and handicaps Temple & Webster's market share at only half that of Wayfair's in the US. Said another way, there are multiple free call options by which Temple & Webster might outperform this base-case estimate. Temple & Webster remains debt-free with A$100 million of cash available on its balance sheet, with expanding profit margins and extremely high returns on incremental capital.

Armed with this information, we were delighted to add to our position in TPW the day that it traded down by 26%. Over the following days we were joined by Temple & Webster's management team which bought back 2.7 million shares. In May, the company announced that it had returned to >10% year-over-year growth in revenues.

During the half we eliminated three of our smallest holdings from the portfolio, **Confluent (CFLT)**, **HashiCorp (HCP)** and **Magnite (MGNI)**, and added three new positions in their place – **Medley (4480)**, **Naigai Trans Line (9384)**, and **InPost (INPST)**. This sort of turnover within our concentrated portfolio is unusual, but it is safe to say that the latter three out-competed the former three from an expected return perspective. I intend to deliver to you a written investment thesis on each of these in the coming months.

In conclusion, I consider it my chief aim in this professional life to faithfully manage the assets that you have entrusted to me. As ever, I am grateful for your continued trust and look forward to the many years ahead of us as we compound our assets together!

Sincerely,

Jake Barfield

Asheville Capital Management FactSheet

Information as of 6/30/2023

Objective: To invest in world-class businesses before they are broadly appreciated as such.

Implication: We will invest with conviction in exceptional companies when we hold a differentiated opinion on their long-term prospects, with a high probability of occurrence. Our companies present asymmetric return profiles due to the existence of variant perception. We have no way of knowing when the variant perception in our businesses will erode and the point at which their exceptional nature will be broadly appreciated as such. As a result, these businesses will experience periods of excess volatility. If our theses are correct, we should experience long-term rates of return that are at least comparable, if not in excess of the rate of return that our companies intrinsic value compounds at, and should expect to generate aggregate portfolio returns that are meaningfully higher than our index benchmark.

Monthly Performance (net of fees)

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	**AshCap**	ACWI	Δ
2022					6.3%	-5.9%	7.0%	-3.9%	-10.9%	4.0%	5.9%	0.5%	**-5.6%**	-2.6%	-3.0%
2023	6.9%	-12.0%	0.3%	0.4%	0.4%	6.2%							**8.0%**	14.2%	-6.2%

Performance Statistics

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Annualized Return	n/a	n/a

Time-Weighted Return

Holdings (Alphabetically Sorted)

Holdings (Alphabetically Sorted)	HQ Location
Acast	Sweden
Agora	China
Elastic	United States
Medley	Japan
Naigai Trans Line	Japan
Raksul	Japan
Temple & Webster	Australia

Terms

Inception Date	May 25th, 2022
Structure	RIA; Seperately Managed Accounts
Broker/Custodian	Interactive Brokers
Management Fee	1%; scales to 0.25% as AUM grows
Incentive Fee	20%; annualy over MSCI ACWI
Minimum Investment	$100,000
Lockup	Not required, but I strongly suggest that you consider the long-term nature of this strategy

Contact Information

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