KIG INVESTMENT MANAGEMENT, L.L.C.

260 Crandon Boulevard, Ste #32 PMB 63
Key Biscayne, FL 33149
Tel: 617-938-3443

January 23rd, 2019

KIG Investment Partnership, L.P.
2018 Letter

Trailing returns	KIG Investment Partnership, L.P.
One year	8.9%
Two years	39.1%
Three years	32.9%
Four years	10.4%
Five years	59.2%
Since inception (February 1st, 2013)	138.8%
Annualized since inception	15.8%

The figures above are net of all costs and fees under the founding partners' terms and 2018 figures are yet to be audited. 100% of KIG's capital is currently invested in ten holdings.

Accepting Volatility with Gratitude

At KIG I invest in exceptional businesses for the long term. These businesses have great people that provide excellent value to customers, generate high returns on capital for shareholders, and know how to reinvest these returns. They are also well aligned with KIG, as all of our management teams themselves own a significant percentage of their respective businesses.

The partnership had unusually high turnover in 2018. I sold five of our businesses at either high or extremely high valuations. Every single one of these investments generated excellent returns. I then reinvested the proceeds into both previously owned and five new exceptional businesses that were selling at very attractive valuations. One might wonder, where are these excellent returns? To help me explain this, allow me to tell you about one of the realized investments I refer to above: Ocado. This investment case should contextualize the partnership's recent performance.

The first investment in KIG's history was Ocado, a UK based company that at the time was the largest pure online grocery retailer in the world. It was co-founded in 2000 by Tim Steiner who is still the current CEO. The company has a superior business model when compared to its offline competitors. Ocado's business model avoids the high real estate and labor costs required to operate stores within cities and incurs high technology costs required to operate highly efficient automated fulfillment centers located outside urban areas. With higher fixed costs it has a business model that scales better. Some might argue that Ocado incurs high variable costs in their last mile deliveries. While true, Ocado is exploring creative ways to bring them down in a dramatic fashion – think self-driving cars. In the meantime, when comparing models, one should keep in mind the opportunity cost of a customer buying in a traditional brick and mortar retailer, as they also spend in personal transportation costs. Most important of all, as a pure online retailer Ocado has access to an impressive amount of data from customers that is used to improve the business in a number of ways.

There are at least two factors currently hiding Ocado's profitability. The first one is that with less than two billion pounds in revenues, Ocado suffers from lower merchandising power than its larger competitors. The company has mitigated this disadvantage by signing a supply partnership with Waitrose. Second, the company has always reinvested aggressively in future growth which has a negative impact on its P&L. Both of these effects should fade over time as the company continues to gain market share and grows in scale.

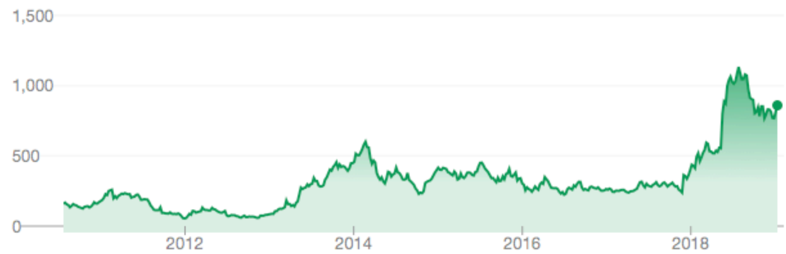
Ocado has a culture of continuous improvement that is reflected in its people, its performance metrics, and its break throughs in new technology. The company also has an impressive track record of customer satisfaction delivering groceries on time and with precision, a challenging task indeed; each order often includes more than one hundred different items, including food that must remain cold! To top it all off, their prices are very competitive. One of the best ways to understand Ocado's achievement is witnessing one of their automated fulfillment centers[1]. A number of years ago, Jeff Bezos told Ocado's management, *"you can do what I do, but I can't do what you do."*

While very rewarding, KIG's investment was not for the faint of heart. During our more than five years invested with Ocado, the company went through a number of different challenges including a capital raise, Amazon becoming an online grocery competitor in the UK, and delays in selling the Ocado Smart Platform (a turnkey solution offered by Ocado to traditional brick and mortar retailers that includes everything from creating a mobile interface, to building highly efficient automated fulfillment centers, to providing their last mile expertise).

In May of 2018 I met with Ocado and asked them questions about their long-term strategic plans. To my surprise they were particularly stiff in their responses. A good friend and fellow investor who was also at the meeting agreed when I said, *"I can't believe how short they were. It was almost as though they did not want to talk with us."* I should have known better. The next morning, I woke up to find their name at the top of the front page of the Financial Times. Ocado had just signed a deal to develop at least twenty sites to build automated fulfillment centers for Kroger, the second largest grocery retailer in the US with revenues of more than US$122 billion in 2017. In the previous months Ocado had already signed a number of deals with other large international retailers – albeit for just one automated fulfillment center in each case – so everyone was waiting for a deal with a US player to be announced. However, the size of the Kroger deal was a big surprise.

[1] Here is a link to a video of Ocado's new warehouse: https://www.youtube.com/watch?v=4DKrcpa8Z_E

Ocado's share price



I bought our first shares of Ocado in February 2013 at 115p, a price that represented a market capitalization of 670 million pounds or about 0.9x Ocado's revenues at that time. As you can tell from the chart above our original investment went up more than 5x in the first year, only to drop by more than 60% in a correction that lasted more than three and a half years. Finally, the shares would go up again more than 4x the following year. I continued buying shares of the company opportunistically over time with our investment in Ocado representing as much as 25% of our capital by late 2017. We sold our last shares, which represented more than a third of our total investment, in June of 2018 at a market capitalization of more than 7 billion pounds or 4.5x Ocado's revenues at that time. While Ocado's business is just getting started, at June 2018's valuation I believe we can generate significantly better risk-adjusted returns investing in other businesses.

Ultimately there were three things that helped me remain confident in this investment: 1) Ocado's superior business model; 2) its strong track record of continuous improvement; and 3) a market capitalization that reflected a steep discount to what I believe was a conservative intrinsic value for the business.[2] None of this would have mattered if it was not for the strength of our partnership. How many investment partnerships do you know that are capable of owning a business in size and buying more of it throughout five volatile years[3]? It does not always work as well as it did with Ocado but the point still holds. KIG is a rare market participant – one that can afford to be patient and invest as a business owner for the long term. Moreover, we can accept volatility with gratitude and buy more shares when the opportunity becomes extremely attractive.

Going back to the original question, where are the excellent returns we realized this year? In any given year KIG has a number of companies priced like Ocado was in late 2016 and early 2017, selling at steep discounts from their intrinsic value. At the same time, we often own a good number of companies priced closer to how Ocado was priced in 2018 – selling at much fuller valuations, with market capitalizations already converging towards their intrinsic values. The end of 2018 was different. For the first time in KIG's history none of our main holdings[4], not a single one, was trading at what I would consider anything remotely close to a somewhat full valuation. As of year-end, discounts to intrinsic value ranged from steep to extremely steep.

[2] Intrinsic value refers to the value of a business calculated by bringing to the present all future cash flows of the company. This is an imprecise exercise which is subject to the quality of assumptions.
[3] I define risk as the probability of impairment of capital. Therefore, I do not see volatility as risk but rather welcome it as an opportunity to profit from.
[4] Our tenth holding is down 33% from its peak but is trading at a fuller valuation. It represents about 0.2% of our assets.

But don't just take my word for it. Recently a limited partner asked me the following question: *"The S&P 500 index corrected almost XX% from its all-time high, how much have your businesses corrected from their respective highs?"* I don't usually pay attention to this metric, so I was quite surprised to discover the following:

Holdings ordered by size	Drawdown from respective high to December 31st, 2018 (in US$)
1	-60%
2	-61%
3	-61%
4	-49%
5	-50%
6	-50%
7	-51%
8	-40%
9	-58%
Weighted Average	-56%

While these numbers do not necessarily prove our businesses are trading at steep discounts to intrinsic value, one thing is for sure: by year-end none of our businesses was enjoying much popularity. This is because they are either 1) domiciled in the UK in the middle of Brexit, 2) have a leveraged balance sheet – with debt that does not start maturing for a good number of years that is being supported by robust businesses generating plenty of cash flow – in the middle of turmoil in the high yield market; or 3) have fast-growing top lines – one of them more than doubled revenues in 2018 – in the middle of fears of an abrupt deceleration.

The situations listed above are not preventing our businesses from making progress. They continue to execute within or above expectations and offer strong reasons to believe they will benefit from the hand they were dealt. While some of them are buying back a significant percentage of their outstanding shares at depressed valuations, others continue to invest and gain market share at an impressive pace.

It is important to emphasize I did not choose these businesses because they were attractively priced. In fact, almost all of these businesses I have either owned – in a much smaller degree – or have identified as exceptional years before their valuations became this attractive. I chose to concentrate our capital in these businesses because they have great people that provide excellent value to customers, generate high returns on capital for shareholders, and know how to reinvest these returns. Brexit, turmoil in the high yield market, or fears of an abrupt deceleration are simply creating the opportunity for us to own these exceptional businesses inexpensively and in size.

"Do they impress?"

"If you judge people, you have no time to love them."

– Mother Teresa of Calcutta

A personal mentor of mine always asks the question *"do they impress?"* when talking about management. This mentor is a very successful investor with a more than twenty-year track record of excellent performance. As you can imagine, when he talks, I do some of my best listening.

Over time I have been internalizing the importance of his question and this year I even made it my own. I found myself asking the exact same question to a colleague who was advocating for a particular manager. He answered by telling me how this manager worked extremely hard and had a ton of experience in his particular line of business. Does this sound impressive to you? To me, the answer was clear.

So, what should one look for? In one sentence, I look for a track record of decisions that point to great character, exceptional judgement and a strong desire to continue learning. That is if I was forced to put it in one sentence, but it is certainly not that simple. Amazon, for instance, has a thoughtful Leadership Principles' outline. You can find it at https://www.amazon.jobs/principles. Please look it up; I promise it will be worth your time. As great as Amazon's or anyone's outline is, checking the boxes is not enough to impress. In my opinion, for a management team to be impressive, in addition to being well rounded, they also need to become world class in at least one specialized skill. World class means that they must compare favorably on this front against pretty much any other team in the world – a very high bar indeed!

I also look for conviction. Not long ago I exchanged opinions with a friend and fellow investor right after spending a couple of hours with the CEO of a business. *"I like him,"* he said. *"But I do not think he has enough conviction. I look for CEOs that actually know they are going to do great."* While the line that separates the confident from the cavalier is thin, I could not agree more with my friend. Through a rare combination of having both the ability to recognize an excellent opportunity and the skillset to address it, there are instances where people just know that their chances to succeed are particularly high.[5] They might not know all the details about how they are going to get there[6], but they know they are very well prepared to overcome almost any obstacles they might find in their ways.

Going back to my mentor's question, there is something else I find remarkable about it: the question is extremely efficient. It makes me skip all the thinking described in the previous paragraphs and go straight to my intuition. There is something about the word "impress" that does this. According to Google the word impress means *"make (someone) feel admiration and respect"*, which explains why I cannot answer the question from an intellectual point of view. To answer, *"do they impress?"* I need to pay attention to my feelings. This explains why if my answer is positive, it is typically a simple and emphatic *"Yes!"*. On the other hand, if I find myself explaining my answer in too much detail, most

---

[5] Please note that I use probabilistic terms. Of course, a degree of luck is always of the essence.
[6] In fact, I am a bit skeptical of those who have it all figured out. I worry that they will be overly dogmatic and not flexible enough to adapt to an ever-evolving competitive environment.

likely I am not impressed.

Final Remarks

The partnership is now open to new capital for the first time in years. For those of us with a long-term horizon, I believe this is a very good time to be investing in KIG. How many investment partnerships do you know that can hold steadily to the shares of exceptional businesses and buy more of them when their prices are off by more than fifty percent? Thank you so much for your trust and patience; it is precisely what makes KIG such a strong partnership.

Sincerely,

Matias Sacerdote