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November 4, 2019

To My Partners:

The performance of our portfolio for the third quarter of 2019 and since inception is summarized below.

	Hinde Model Account		S&P 500
	Gross	Net	Total Return
2019:			
Q3	-11.78%	-12.11%	1.70%
Year-to-Date	5.09%	3.91%	20.55%
Since Inception (07/01/15):			
Annualized	10.70%	9.05%	11.28%
Cumulative	54.03%	44.49%	57.46%

On July 31st, the Federal Reserve cut its target range for the federal funds rate by 25 basis points to 2.00% - 2.25%. It was the first time the Fed had cut interest rates in more than a decade. The decision to ease monetary policy came in response to clear signs of slowing growth in the U.S. economy, persistently below-target inflation, and falling long-term inflation expectations. It followed similar actions by central banks around the world. The disruption and uncertainty created by Trump's trade wars, especially his campaign against China, are weighing on the global economy.

Before the ink had dried on the Fed's post-meeting statement, Trump was back on Twitter. On August 1st, Trump threatened China with 10% tariffs on an additional $300 billion of exports to the U.S. The new tariffs, planned to go into effect on September 1st, came on top of the 25% tariffs that Trump had previously slapped on $250 billion of Chinese exports to the U.S. Trump had reportedly been disappointed with the progress in trade negotiations with China, and presumably felt further threats would improve the situation. Virtually all the products the U.S. imports from China will soon be subject to tariffs.

China responded within days by letting its currency weaken past RMB 7 to the U.S. dollar, a symbolic threshold. China's immediate parry of Trump's attack made it clear – if it was not already – that China would not simply succumb to coercion. Later in August, China announced retaliatory tariffs on $75 billion of imports from the U.S. Although China's tariffs were a measured response to the tariffs Trump announced on August 1st, Trump immediately escalated tensions further by announcing a 5% increase to tariff rates on all imports from China.

Global financial markets had less than a day to bask in the Fed's first interest rate cut in a decade. Stocks fell and bonds rallied over the course of August as trade relations between the U.S. and China took a rapid succession of blows. The yield on the 10-year U.S. treasury, which moves inversely to its price, plummeted from just over 2.00% at the end of July to 1.50% by the end of August. At that level, the 10-year yield was pricing in a substantial degree of economic weakness, multiple further cuts to the federal funds rate and a high likelihood of a recession.

Financial markets rebounded somewhat in September. Certain economic data pointed to continued resilience in the U.S. economy, and the Fed once again cut the federal funds rate by 25 basis points at its meeting in September.

The relief rally notwithstanding, the economic outlook remains tenuous. Trump's trade wars have pushed the global economy to the precipice. At the same time, the Fed is divided – two members of the FOMC have voted against each of the Fed's recent interest rate cuts – and may be reluctant to respond to slowing growth with alacrity. The odds of a recession over the next two years are elevated.

Our portfolio underperformed on a mark-to-market basis during the third quarter. Our position in Covetrus, Inc. (NASDAQ: CVET) accounted for essentially all of our underperformance for the quarter and year-to-date. CVET declined by 51.4% during the third quarter. Most of that decline occurred after the company reported second quarter earnings. Although Covetrus has stumbled out of the gate, our thesis remains intact. I am confident our investment in CVET will deliver exceptional returns over time, and I expect the market price of CVET to recover substantially over the next few quarters. There is an extensive discussion of the position later in this letter.

Performance Attribution

Positions that had a material impact on the portfolio's mark-to-market performance for the quarter and year-to-date are outlined below.

Performance Attribution			
3Q 2019		YTD	
Alphabet	1.81%	Fastenal	4.62%
TopBuild	0.92%	TopBuild	4.27%
Northeast Bank	-3.04%	Northeast Bank	3.67%
Covetrus	-11.03%	Alphabet	2.87%
		Colfax	2.68%
		Retail Value	2.12%
		Waters Corporation	1.53%
		Amazon.com	1.10%
		Covetrus	-17.32%
Other	-0.45%	Other	-0.47%
Gross Performance	-11.78%	Gross Performance	5.09%

Portfolio Composition

The composition of the portfolio at the end of the quarter is depicted below.

Portfolio Composition	
Equities – Long	75.3%
Cash	24.7%

Our transactions during the quarter were primarily driven by risk management considerations in light of the tenuous economic outlook. We exited our positions in Retail Value, Inc. common stock (NYSE: RVI) and TopBuild Corp. common stock (NYSE: BLD), and substantially reduced our position in Colfax Corporation common stock (NYSE: CFX).

Selling BLD was an especially difficult decision. Hinde Group aims to achieve long-term capital gains treatment for its investments and defer realization of taxable gains as much as possible. In this case, we would have had to hold BLD until March 2020 to achieve long-term capital gains treatment. I did not feel the benefit of continuing to hold the position for that long clearly outweighed the risks and opportunity costs.

At the end of the quarter, our portfolio included seven long equity positions and cash.

Select Portfolio Updates

The two portfolio updates for this quarter cover our positions in Covetrus, Inc. common stock (NASDAQ: CVET) and Interactive Brokers Group, Inc. class A common stock (NASDAQ: IBKR). Both positions have been a drag on our performance thus far in 2019, but I remain confident they will both deliver terrific returns over time.

Covetrus, Inc.
(NASDAQ: CVET)

Covetrus is a global animal health technology and services company. It was created earlier this year through the merger of Henry Schein Animal Health, one of the leading distributors of medications, supplies and equipment to veterinary practices, and Vets First Choice, an innovative, animal health-focused prescription management platform that is still in the early stages of adoption by veterinary clinics.

As part of Covetrus's second quarter earnings report in mid-August, management lowered its guidance for the year. Management now expects to achieve EBITDA of at least $200 million instead of its prior guidance of $235 million to $250 million. The market did not take the news well, sending the stock down about 40% on the day.

Several factors contributed to the reduced outlook.

First, Covetrus experienced soft demand in its North American supply chain business in May and June. The company attributed the softness to weak traffic to veterinary clinics and competitive pressure on pet medication sales through the veterinary channel. Changes to pet medication manufacturer distribution policies may have also caused gray market sales of pet medications to dry up. Covetrus believes it at least maintained its share of the veterinary distribution market. The company lowered its assumption for North American supply chain market growth for the year to a decline of around one percent from an increase of two to three percent.

Second, Covetrus experienced a lull in orders in its U.K. supply chain business. In anticipation of potential Brexit-related shortages, vets in the U.K. had stocked up on pet medications and other critical supplies in advance of the original March 29th deadline for Brexit. The stocking activity helped Covetrus report robust, 5% organic growth in its European supply chain business during the first quarter. That benefit reversed during the second quarter as vets shifted from stocking to destocking once Brexit was postponed.

Third, the company made the decision to accelerate the timing of certain information technology investments related to the integration of Vets First Choice and Henry Schein Animal Health. The accelerated investments will allow Covetrus to more quickly exit transition services agreements with Henry Schein and realize the benefits of the merger. At the same time, the accelerated investments will result in a higher level of duplicative costs until those agreements are exited. Covetrus also reclassified $10 million to $15 million of its $100 million of planned integration-related investments from one-time investments to on-going operating expenses.

Finally, changes in foreign exchange rates also weighed on Covetrus's outlook. The strength of the dollar since the beginning of 2019 relative to the euro, British pound, and Australian dollar likely accounted for $2 million to $3 million of the guidance reduction for the year.

Most of the factors behind Covetrus's reduced guidance, such as the Brexit impact, the acceleration and reclassification of integration-related investments, and the impact of the dollar's strength in the first half of 2019, are one-time in nature and relatively modest in size. They do not materially alter the level of earnings Covetrus should be able to achieve over the next several years or put the conservative assumptions used to underwrite our investment at risk. These one-time factors probably accounted for about half of the reduction in Covetrus's EBITDA guidance.

The remainder of Covetrus's reduction in EBITDA guidance came from the company's more cautious outlook for the U.S. veterinary distribution market. While the forces weighing on the U.S. veterinary distribution market, such as increased competition from non-veterinary retailers of pet medications, are here to stay, the magnitude of the headwind they create is unlikely to be sufficiently large to invalidate our investment thesis. Industry data and comments from other animal health distribution companies suggest that May and June were especially soft months for U.S. veterinary clinics and that demand in the veterinary distribution market is relatively stable despite the channel shift that is occurring. Moreover, most major pet medication manufacturers have implemented minimum advertised pricing policies over the past few months to support the veterinary channel. Online prices for many pet medications are up 20% to 50% from where they were during the first half of the year. Competition from alternative retailers of pet medications may also serve as an impetus for vets to accelerate their adoption of Vets First Choice. The headwinds facing the U.S. veterinary distribution market may subtract two to three percentage points from Covetrus's annualized earnings growth over the next several years. Even if that is the case, Covetrus should still be able to grow its earnings at a compound rate in excess of 20%, a rate comfortably above the conservative assumptions used to underwrite our investment.

The vast majority of Covetrus's earnings growth over the next several years will come from the continued growth of Vets First Choice, a business with a dramatically higher margin profile than the legacy supply chain business, and the realization of merger-related synergies. Adverse developments on those fronts would call our thesis into question, but the news there has actually been positive.

Revenue on the Vets First Choice platform grew by 46% year-over-year in the second quarter. Practices enrolled on the platform in 2017 or earlier grew revenue by 16%. Vets First Choice ended the second quarter with more than 8,700 enrolled practices in the U.S. For the full year, it expects to enroll 3,000 new practices, bringing its base of enrolled practices to more than 10,000. That would represent a 40% increase for the year. The company remains on-track to launch the platform in Europe in 2020.

Similarly, the initial signs of Covetrus's ability to capture value from the combination of Vets First Choice and Henry Schein Animal Health are encouraging. There is clear evidence that Henry Schein Animal Health's U.S. salesforce is successfully driving greater engagement on the Vets First Choice platform. Newly enrolled practices are both beginning to generate sales ("activating") more quickly and achieving meaningfully higher initial sales than practices enrolled in prior years. Although enrollments were up 20% sequentially in the second quarter, activations were up 40%. Accounts enrolled in 2019 that had a full quarter of sales by the end of the second quarter generated 50% more revenue on the platform in their first 90 days than the average of historical cohorts. There is a massive opportunity for the company to improve engagement with the Vets First Choice platform among existing enrolled practices, and the company is currently in the process of rolling out programs with precisely that focus. Covetrus also remains on-track to achieve the cost-related portion of its synergy targets.

You may wonder why the stock has performed so poorly if the thesis is still intact. The answer simply comes down to confidence. Covetrus's stumbles out of the gate have led to a complete collapse of investor confidence in the company. Most market participants rely almost exclusively on company management for information. If something causes management's credibility to erode, those investors no longer have anything to hold onto. They will only value that company based on what is right in front of their face. Just like the potential of Netflix's streaming business in 2012 or the potential of Amazon Web Services in late 2014, the potential of Vets First Choice – especially when combined with the capabilities of Henry Schein Animal Health – takes hard work to independently understand and verify. Few investors do that work. As a result, the substantial value that a well-informed, long-term oriented investor would ascribe to Vets First Choice is nowhere to be found in Covetrus's stock price at the moment.

The stock market's overreaction notwithstanding, Covetrus's management team should not simply be excused for the company's early stumbles. With the benefit of hindsight, it is clear that management did not have all of its ducks in a row at the time Covetrus completed the merger and became a publicly-traded company. It has also become increasingly clear that Ben Shaw, the entrepreneurial and visionary founder of Vets First Choice, is not the best person to run Covetrus as a publicly-traded company.

Fortunately, Covetrus's board of directors has been assertive in addressing the situation. On September 4th, the board appointed an independent chairman to improve oversight of management. Six weeks later on October 22nd, the board announced that Ben Shaw would step down as CEO. The board made the right decision in replacing Ben Shaw, and I am optimistic that the company will achieve its full potential under new leadership.

No investment ever turns out exactly as you expect. Our investment approach explicitly accounts for that by using conservative underwriting assumptions that reflect meaningful haircuts to our best estimates of how a business will actually perform. Although Covetrus has clearly had a few early stumbles, its performance over time should still handily exceed our underwriting assumptions.

Interactive Brokers Group, Inc. (NASDAQ: IBKR)

On September 26th, Interactive Brokers announced the launch of IBKR Lite, a zero-commission trading service, and the rebranding of its professional-grade offering as IBKR Pro. IB's standard commission rate, which will continue to apply to IBKR Pro, had been $0.005 per share with a minimum commission of $1.00 per trade.

Less than a week later, Charles Schwab responded by eliminating trading commissions for stocks, ETFs and options listed on U.S. and Canadian exchanges. Charles Schwab had previously charged $4.95 per trade. TD Ameritrade, E*TRADE, Fidelity and most other brokers quickly followed suit.

The abrupt, industry-wide shift to zero commission trading will hit some online brokers hard. Brokers like TD Ameritrade and E*TRADE have historically generated a substantial portion of their revenue and income from trading commissions and have already been exploiting the opportunity to sell their client's orders to high frequency trading firms. The shift to zero-commission trading represents an absolute loss of revenue and income for those brokers without any offsetting benefits.

In contrast, Interactive Brokers should be relatively unscathed by the change for a few reasons.

First, Interactive Brokers designed IBKR Lite to be at least revenue-neutral relative to IBKR Pro. IBKR Lite will offset the loss of trading commissions by i) receiving payments for directing client orders to high frequency trading firms instead of using IB SmartRouting and ii) offering less favorable interest rates on margin loans and cash balances than IBKR Pro.

Second, Interactive Brokers will still be the all-in price leader by a wide margin. Although the advantage Interactive Brokers offers its clients on commission rates will disappear, Interactive Brokers will continue to offer meaningfully better margin rates, interest rates on cash balances and execution quality. For example, Interactive Brokers currently charges 3.40% on a $25,000 margin loan while Charles Schwab and Fidelity would each charge 8.82% for the same loan.

Third, zero-commission trading is only relevant to U.S.-based individual customers, a relatively modest portion of IB's geographically diverse and professional-leaning customer base. U.S.-based individuals account for 15% to 20% of the company's existing customers and only 10% to 15% of its net new customers. Even if the flow of net new U.S.-based individual customers to Interactive Brokers were cut in half, the company's account growth rate would slow by only around 1%.

Finally, offering IBKR Lite may allow Interactive Brokers to appeal to a broader set of potential customers, especially introducing brokers for whom payment for order flow is a key aspect of their business model. The benefits of offering IBKR Lite could equal or even exceed the negative impact of a more competitive pricing environment.

Naturally, the market has not taken such an even-keeled and nuanced view thus far. Concerns about zero-commission trading come on top of others that have been weighing on IBKR since it hit a high above $80 per share in May 2018. Specifically, market participants have shunned the stock due to unfavorable developments with respect to interest rates and capital controls in China. While both of those near-term headwinds will turn into equally-sized tailwinds in the future, the apparent timing of those changes sits beyond the horizon of most investors at the moment. Interactive Brokers has grown its number of customer accounts, the primary long-term driver of its earning power, by 22.9% since June 2018, but IBKR's market price is down by 16.5% over the same time period.

Although our position in IBKR has been a drag on our performance over the past 16 months, I remain confident we will earn excellent returns over time. Interactive Brokers is the epitome of a great business, and its recession-resistant characteristics are especially attractive at the moment. The company should be able to grow its earnings at a high-teens rate through the next economic cycle while also generating a modest amount of distributable cash flow. Moreover, IBKR's current valuation multiple has tremendous scope for improvement. From its price at the end of the third quarter, IBKR is poised to deliver a compound annual return in excess of 20% over a multi-year period. IBKR would be more fairly valued today at $100 per share or more.

I am sure you are disappointed by the portfolio's mark-to-market performance during the third quarter. I do not believe the market value of our portfolio – CVET especially – is at all reflective of its intrinsic value. Unless I am completely wrong about the outlook for Covetrus's business, there is simply no way the stock can continue to languish where it is for very long. I look forward to reporting a strong rebound in performance to you in the coming quarters.

Thank you for your continued confidence and support.

Regards,

Marc Werres
Managing Partner

Important Disclosures

The performance figures depicted herein relate to the Hinde Model Account. This account serves as the model account for the taxable accounts Hinde Group manages. The performance of investor partner accounts may differ from the figures depicted herein for several reasons, including, but not limited to, cost basis differentials, the timing of account inflows, and tax considerations. The Hinde Model Account’s gross results reflect the deduction of trading commissions and other fees charged by Hinde Group’s broker. Net results reflect the hypothetical deduction of management fees (1.5% of AUM per annum billed quarterly in advance).

The Hinde Model Account’s inception date is July 1, 2015.

The statistical data regarding the performance of the S&P 500 was obtained from the website of S&P Dow Jones Indices. The S&P 500 returns shown do not represent the results of actual trading of investible assets/securities.

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