HINDE GROUP

A 580 California St.
16th Floor
San Francisco, CA 94104
T (415) 992-8125
W hinde-group.com

November 4, 2021

To My Partners:

The performance of our portfolio for the third quarter of 2021 and since inception is summarized below.

	1578 Partners, LP		S&P 500
	Gross	Net	Total Return
2021:			
Q3	-8.43%	-8.78%	0.58%
Year-to-Date	7.19%	5.99%	15.92%
Since Inception (08/01/15):			
Annualized	17.23%	15.48%	14.54%
Cumulative	166.48%	142.88%	130.89%

A few times a year, the Federal Reserve Bank of Philadelphia polls professional economists for their forecasts of various economic variables. It publishes the results in its *Survey of Professional Forecasters*. In the May 2021 edition, the median forecast for U.S. real GDP growth during the third quarter was 7.5%. It turns out the economy missed that mark by a mile. The Bureau of Economic Analysis published its first estimate of annualized real GDP for the third quarter a few days ago. It estimated the economy grew at just 2.0% annualized.

Two factors caused the economy to sputter. First, the spread of the highly infectious delta variant of SARS-CoV-2 led to a resurgence of COVID cases worldwide. Social distancing measures tightened, and many people became more cautious. Second, supply constraints related to the reopening of the economy worsened. If you have tried to purchase pretty much any physical good over the past several months, chances are you had to wait longer or pay more than you might have expected – if you were able to get what you wanted at all.

Not all the companies in our portfolio have been immune to the effects of the supply disruptions hitting the economy. Uber Technologies has struggled to recruit enough drivers to meet the resurgence in demand for rides. Covetrus has faced stock-outs of certain therapeutic pet foods due to shortages of key active pharmaceutical ingredients used in manufacturing those diets. Sleep Number's backlog of unfilled orders has ballooned due to shortfalls in essential materials and components used in the production of its mattresses. These adverse effects will weigh on the performance of these companies in the immediate term, but will ultimately prove to be both manageable and temporary.

Our portfolio has experienced an unusual degree of mark-to-market volatility this year. In mid-March, we were sitting on a mark-to-market gain for the year of just over 33%, well ahead of the S&P 500. The market prices of our stocks have been nothing but uncooperative since, including during the third quarter. It seems that companies perceived to have benefitted from the pandemic have now become categorically and indiscriminately out of favor. The whims of other market participants notwithstanding, all of the companies in our portfolio remain on track to exceed the financial results we underwrote. There have been no developments at any of our companies that justify the unfavorable mark-to-market performance that our portfolio has experienced over the past several months. Our portfolio was deeply undervalued even at its mark-to-market peak in mid-March, and it is even more so today.

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 2021		YTD 2021	
Northeast Bank	1.29%	Alphabet	8.35%
Equities – Short	1.25%	Northeast Bank	4.38%
Alphabet	1.24%	Sleep Number	2.81%
Interactive Brokers Group	-1.11%	Equities – Short	1.26%
Sleep Number	-4.02%	Covetrus	-9.49%
Covetrus	-6.78%		
Other	-0.29%	Other	-0.12%
Gross Performance	-8.43%	Gross Performance	7.19%

Portfolio Composition

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

Portfolio Composition	
Equities – Long	94.2%
Equities – Short[1]	-7.8%
Cash[2]	14.8%

During the quarter, we reduced our position in Sleep Number Corporation common stock (NASDAQ: SNBR), a special situation investment, and added to our positions in Interactive Brokers Group, Inc. Class A common stock (NASDAQ: IBKR) and Uber Technologies common stock (NYSE: UBER), both compounders. At the end of the quarter, our portfolio included nine long equity positions, one short equity position, a long position in out-of-the-money calls that hedges the short equity position and cash.

Select Portfolio Updates

Hinde Group analyzes the valuation of each compounder investment primarily in terms of the prospective returns it offers at its current market price, not in terms of a price target. The prospective return for any equity security over a given time horizon can be broken down into four buckets: i) annualized core earnings growth, ii) yield from cash generation, iii) return from capitalization rate change, and iv) return from non-core capital allocation, such as acquisitions and share repurchases. The longer you intend to hold a security the more important core growth, cash generation and non-core capital allocation become and the less important capitalization rate change becomes. For most compounders, only the first three buckets are meaningful contributors to the prospective return. Although our holding period for compounders is indefinite, Hinde Group uses a seven-year time horizon to evaluate the prospective returns of compounders.

[1] Reflects the combined delta-adjusted exposure of a short stock position and a long position in out-of-the-money calls that hedges the short stock position.
[2] Includes cash collateral related to short positions.

The portfolio updates for this quarter apply that framework for analyzing prospective returns to our positions in Covetrus, Inc. common stock (NASDAQ: CVET) and Interactive Brokers Group, Inc. Class A common stock (NASDAQ: IBKR). These two positions combined have been a meaningful drag on our mark-to-market performance over the past few years. Nonetheless, I am confident both positions will ultimately deliver good, if not exceptional returns for us when all is said and done. Hopefully these updates will give you a better sense of why.

Covetrus, Inc.
(NASDAQ: CVET)

> *"Our organic year-over-year net sales growth in 2021 is expected to be in the high single digits, which is more reflective of our long-term growth opportunity."*
>
> *– Ben Wolin, CEO on the 4Q20 earnings conference call*
>
> *"…the overall goal here is to transform the whole company from that 5% to 6% EBITDA range into the 10% range."*
>
> *– Ben Wolin, CEO at the Credit Suisse Healthcare Conference*
>
> *"Our net leverage is now just slightly above our long-term target range of 3 to 3.5x, a level we believe is appropriate given the stability of our business and the inherent free cash flow generation of the company, which should approach 50% of adjusted EBITDA over time…"*
>
> *– Matthew Foulston, CFO on the 4Q20 earnings call*

Covetrus is a global animal health technology and services company. It was created in early 2019 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.

Favorable trends in the animal health market and continued adoption of Covetrus's high margin prescription management platform among the 100,000 veterinary clinics Covetrus serves around the world should drive robust earnings growth for Covetrus for the foreseeable future. Total company revenue growth should steadily accelerate toward 10% as the fast-growing prescription management business becomes a larger piece of the company. Similarly, Covetrus's adjusted EBITDA margin should roughly double to 10% as the mix of business shifts toward higher margin sources, such as prescription management, compounded medications and private label products, and as significant cost reduction opportunities are realized. The combination of high single digit compound annual revenue growth and a doubling of the company's adjusted EBITDA margin would result in compound annual adjusted EBITDA growth in the mid-to-high teens. Through fixed asset and financial leverage, mid-to-high teens adjusted EBITDA growth would translate into <u>compound annual earnings growth in the mid-20% range</u>.

The momentum that Covetrus's earnings growth is building should already be plainly evident to anyone who cares to look closely enough. For 2021, Covetrus expects to achieve adjusted EBITDA between $245 million and $255 million, or an 8.4% to 12.8% increase over last year. At first glance, that might seem to fall short of the company's target going forward, but it is essential to keep in mind that Covetrus has had to invest a substantial amount in building out its corporate infrastructure over the past several quarters to complete the corporate-level integration of Henry Schein Animal Health and Vets First Choice. Increased corporate overhead was a $17 million drag on adjusted EBITDA growth in just the first half of 2021, and will likely be around a $30 million headwind for the full year. In other words, were it not for the one-time step-up in corporate overhead over the past several quarters, Covetrus's adjusted EBITDA growth would likely clock in north of 20% for the current year. This underlying momentum in Covetrus's earnings growth should become more evident next year and beyond as outsized growth in corporate overhead ceases and cost reduction projects begin to bear fruit.

Covetrus should not only deliver exceptional earnings growth going forward, but also spit out a bunch of cash while doing so. The business is capital light overall, and its fastest growing portions are especially so. Management aims to convert 50% of adjusted EBITDA to free cash flow over time. Excluding the benefit to free cash flow from stock-based compensation, that translates into approximately 90% of net income being converted to free cash flow. With such a strong cash generation profile and with the stock trading at a forward earnings yield of just over 5.0%, cash generation alone should contribute more than 3.0% to the annualized return CVET delivers over the coming years.

Last but not least, CVET seems poised to also deliver meaningful returns from improvement in the stock's capitalization rate over time. Covetrus should ultimately prove itself to be a high quality, recession-resistant, cash flow generative and fast-growing business. CVET currently trades at just over a 5.0% yield relative to Hinde Group's estimate for 2022 earnings. No one can say precisely at what capitalization rate CVET will trade as the market comes to better understand and appreciate the company, but it should certainly be better than the current one. Fastenal, a company in our portfolio that has some similarities to Covetrus, provides just one point of reference. Although Fastenal is more cyclical and offers slower growth than Covetrus, FAST currently trades at roughly a 3.0% yield relative to the consensus earnings estimate for 2022. If CVET's capitalization rate were to improve from its current 5.0% to FAST's 3.0% over the next seven years, capitalization rate improvement would add more than 7.0% to the stock's annualized return over that period. There are good reasons to think CVET's capitalization rate could improve to an even greater extent.

Putting those three components together – i) more than 20% annualized earnings growth, ii) more than 3.0% annualized contribution from free cash generation, and iii) more than 7.0% annualized contribution from capitalization rate improvement – yields a prospective compound annual return over the next seven years from CVET of more than 30%. If market participants were to come to better understand and appreciate Covetrus on a shorter timeline than our seven-year underwriting horizon, the annualized return could be much higher. An aggressive share repurchase program could also meaningfully add to the returns that CVET ultimately delivers.

Interactive Brokers Group, Inc. (NASDAQ: IBKR)

"Our goal now is 80 million accounts or 1% of world population. How long will that take? We are not sure, but think 10 to 15 years. It is encouraging that there is one country today, which I'm not going to name, where we have accounts from over 1% of its population."

– Thomas Peterffy, Founder & Chairman on the 4Q20 earnings conference call

"…we believe year-over-year growth of total accounts can be at least 30% going forward indefinitely."

– Thomas Peterffy, Founder & Chairman on the 3Q21 earnings conference call

Interactive Brokers ("IB"), a highly automated global securities firm, specializes in routing orders and processing trades in securities, futures, foreign exchange instruments, bonds and mutual funds on more than 135 electronic exchanges and market centers around the world. Interactive Brokers custodies and services accounts for hedge and mutual funds, registered investment advisors, proprietary trading groups, introducing brokers and individual investors.

Interactive Brokers has enormous growth potential. It is the low-cost provider of brokerage services in the world due to a unique and hard-to-replicate level of automation combined with economies of scale. Its platform is also favorably differentiated relative to other brokers in terms of its technological sophistication and breadth of features and tradeable products. Interactive Brokers has a large opportunity to grow by raising awareness and perceived value of its platform among potential customers around the world. At the same time, Interactive Brokers is relentlessly and continuously improving its platform to provide ever more value to existing and prospective customers. The launch of disruptively priced cryptocurrency trading is only the most recent example. Thomas Peterffy, the Founder and Chairman of Interactive Brokers, aims to grow IB's account base at a compound annual rate of at least 30% until the company reaches 80 million accounts globally, more than *50 times* larger than its current size. While you can't take aspirations to the bank, Thomas Peterffy is one of the last business people on the planet you should bet against. Even if Interactive Brokers comes up somewhat short of his account growth aspirations, it should still be able to deliver annualized revenue growth of more than 20% for the foreseeable future, especially considering the benefit IB will realize from a normalization of benchmark interest rates around the world over time. Continued improvement in execution and clearing expense rates and modest leverage on fixed costs should result in pre-tax income growing somewhat faster than revenue. Putting that all together, Interactive Brokers seems poised to deliver <u>annualized earnings growth at least in the high-20% range</u> over our seven-year underwriting horizon.

Although IB's business is highly efficient in terms of physical capital, it does require financial capital to support the financing needs of its fast growing customer base and to continue to bolster its attractiveness as a counterparty to sophisticated institutional investors. In other words, the faster Interactive Brokers grows, the less free cash it is able to distribute. Interactive Brokers currently pays a quarterly dividend of $0.10 per share, which amounts to a payout ratio of just over 10%. At some point, the company will likely substantially increase its dividend payout ratio even as it continues to grow, but it is difficult to say when exactly that point will come. For now, <u>the current dividend offers a 0.5% yield</u>, which approximates the contribution of cash generation to IBKR's prospective return.

Like CVET, IBKR should benefit from capitalization rate improvement over time. Interactive Brokers is a great business with especially abundant growth opportunities. Historically, IBKR has traded at a median forward earnings yield below 4%, and there are strong arguments for IBKR deserving a better earnings yield than either FAST or CVET. Yet it currently trades at an earnings yield of more than 6.0% relative to Hinde Group's earnings estimate for 2022. If IBKR's forward earnings yield were to improve over the next seven years to be just inline with FAST's 3.0% forward earnings yield, <u>capitalization rate improvement would contribute more than 10.0% to IBKR's annualized return</u>.

Between annualized earnings growth in the high-20% range or more, a 0.5% dividend yield and a 10.0% benefit to annualized returns from capitalization rate improvement, IBKR appears poised to deliver a compound annual return over the next seven years approaching 40%. This prospective return estimate is based on Interactive Brokers falling well short of Thomas Peterffy's aspiration for annual account growth of at least 30%. IBKR's annualized returns would also be even higher if appreciation of and sentiment toward the company were to improve faster or more fully than what those figures imply.

Although the dark days of March and April 2020 are behind us, the effects of the pandemic continue to cast a cloud over the economy and distort financial markets. The mark-to-market performance of our portfolio this year has been frustrating, both in terms of volatility and performance. Nonetheless, I remain confident that intrinsic values of the securities we own, which far exceed their respective market prices at the moment, will ultimately shine through.

Thank you for your continued confidence and support.

Regards,

Marc Werres
Managing Partner

Important Disclosures

The performance figures depicted herein relate to 1578 Partners, LP. 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. 1578 Partners, LP'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).

1578 Partners, LP's inception date is August 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.

Past performance is not necessarily indicative of future results. All investments involve risk, including the loss of principal. The views expressed herein are those of Hinde Group as of the date indicated and may change without notice. Hinde Group may buy or sell any security at any time and is under no obligation to provide updates to the information contained herein. This is not a recommendation to buy or sell any security.