Investor Newsletter – September 2019

We seek asymmetric investment opportunities informed by the coalescence of rigorous fundamental analysis and alternative data discovery.

The Geometrica Fund aims to deliver outstanding returns to unitholders via highly targeted investments in the global mid-cap equity universe.

Overview

September was the first month of investing for the Geometrica Fund.

Net of costs and fees the Fund closed the month +1.1% (Founders Class).

Half-way through the month, 6.2% of capital at cost had been deployed into a handful of equities; by month end this was 21.6%. By October 1st, given modest fund inflows, that had dropped to 10.4% but was back up to 15.4% at the time of writing.

We expect to deploy capital over the next 4 to 6 months and be at a point of ~80% equities / cash within that timeframe.

That's not a promise, more a working target.

We don't want to move too quickly; we'd rather be opportunistic and greedy for attractive and asymmetric returns. This is how we invest our own money, which sits alongside yours, in the Geometrica Fund.

We'd like to thank our foundation investors. We know almost all of you. A humble thank you. This endeavour would not have been possible without you.

At the start of any relationship, communication is crucial. With that in mind, this letter will be a bit longer than the typical investor letter we'd write. Future letters are likely to contain greater numerical detail, but for now given the paucity of historical return information, this letter is going to be long on text and short on tables and charts.

Because a lot of what we discuss is going to play out as a real-life experiment in a temporal sense, it is inevitable that we are going to make mistakes.

We'd love to tell you that some deep knowledge of ours informs an infinitely scalable and widely diversified model portfolio capable of significant outperformance. But we don't think investment markets, discounting machines as they are, work that way.

Portfolio notes

US Consumer Stock

Our largest position at month end was in a listed US consumer business, where we see significant upside. As we are ongoing buyers, we won't divulge the name. But we can describe the current situation as we see it, what we think might change that the market is not yet pricing in and what that might mean for our investment in the fullness of time.

This stock is an orphan. The current level of sell side broker coverage verges on neglect. It is located in a small, sleepy city and generates absolutely no profit at all; it has reported small losses recently.

What's *really* interesting is that it has adopted a business model we have seen used to great effect in other markets over the years and is at a point where its burgeoning scale should start to translate into rapidly improving profitability.

Part of our attraction to the stock is that it prices its main product at a premium level. Yet when you look through the P&L, this pricing premium doesn't yet translate into profitability because an

elevated level of costs masks the latent return generative nature of the business.

A dissection of these costs shows that the two largest line items are running at levels *way* above established peers in other markets. Our work indicates these costs as a percentage of revenue should structurally decline as the business scales; for one of these cost lines the game is already afoot and for the other we envisage a step change down over the next one to two years. This should prove quite the tonic for operating margins.

Relatedly, we think revenues are tracking 30% - 40% *above* consensus expectations, based on some bespoke work we have done on customer traffic and spending patterns. If we are fortunate enough to see the expected revenue surprise collide with an inflection in margins and profitability, then we are hopeful that the stock and its earnings profile will rerate materially.

Corporate Travel Limited (CTD AU, mkt cap A$1.9bn). A Corporate Fraud?

On 28 October 2018, a 176-page presentation prepared by a hedge fund was published, depicting the stock as a potential earnings fraud (nowhere in the presentation is the "F" word used, but the sum of "*20 red flags*" seemed to lead the reader to that conclusion). The presentation is easily searchable on google.

The next trading day CTD's stock price fell 27.5%. CTD at the time of writing was trading at $17.71, fully 47% down from its high of $33.45 in September 2018.

The thing about outright earnings frauds is that they tend to go to zero. So, in the context of potential percentage returns, whether you short at $33.45 or at $17.71 is irrelevant; either way you make a 100%. So, we took a look given stock borrow was readily available and we've seen quite a few fraud stocks over the years.

CTD has been listed since December 2010, so there are fully 10 years of annual financial statements.

That's important because the longer an earnings overstatement fraud persists, the more bizarre its balance sheet must become.

If you wanted to overstate your earnings each year, you could either create a fraudulent sale or fraudulently reverse an expense; either way you wind up with a fake credit entry to a P&L account which results in higher reported earnings.

The issue with one fake accounting entry is that it necessitates a second; this balancing is the essence of double entry book-keeping.

So, a fake credit to a P&L account typically necessitates a fake debit to a balance sheet account in an earnings overstatement fraud.

Consequently, most earnings frauds we've seen manifest in either faked cash, debtors, inventory or PPE (property plant & equipment) or some cocktail thereof. We could regale you with some doozies. *And the longer the fraud persists, the bigger the lie must grow*.

The reason the balance sheet gets more bizarre with time is that P&L accounts measure a *flow* concept and balance sheet accounts measure a *stock* concept. In year 1 if you overstate sales and debtors by $10 its simple. But when you do it again in year 2, you have fake sales of $10 for year 2, but the fake asset balance is now $20 ($10 from year 1 plus $10 from year 2). By year 10 your faked debtors are blowing out to $100 as you record another $10 of faked sales.

The longer the fraud persists, the bigger the lie must grow. This is why persistent earnings frauds collapse so spectacularly.

If you take up the baton of the short case and assume since 2014 CTD really only grew earnings by 15% a year, you wind up with an implied $190m of asset overstatement. That number is implausibly large as a percentage of debtors (57.6%) for a company without customer

concentration in an audit environment that uses random sampling for debtor confirmations.

There are aspects of the debate on "earnings quality" that we've witnessed on this stock that approach the level of absurdity.

If anything, the episode to date just shows that markets really do, in the short-term at least, discount participant expectations, not fact.

Our take on CTD

CTD has been criticised as having a growing reliance on Volume Based Incentive Revenue (VBIR) or "overrides" and the accounting for these. These are principally paid by 3 Global Distribution Systems (GDS), who in turn are paid by the airlines. The VBIR payments represent the second largest revenue source beside customer payments, are effectively sourced from suppliers, and are growing fast.

The GDS were formed decades ago by airlines, who initially created CRS (Computer Reservation Systems) of their own. A GDS has the benefit of offering fares and other product from multiple vendors in a standardised way to facilitate bookings. Complexity drove the GDS use case: a vast number of airlines, replete with route, class, timetable and inventory complexity, necessitated a centralised reservation system. Amadeus the largest of the GDS supports around 200 airlines presently.

The GDS now have a stranglehold on distribution of airline bookings. They dominate the distribution landscape and they continue to grow segments booked. Airlines have been trying for years to diminish their power and the efforts continue; to date all to no avail.

Contracts between GDS and airlines require the latter to pay the GDS fees every time a segment booking is made. On a segment basis, this works out at a little under 5 euros for every segment booked through Amadeus, the largest of the GDS with market share of over 40% of GDS segment bookings.

Because the GDS contractually have guaranteed revenue for segment bookings, it makes economic sense for them to *acquire* segment bookings. They do this via offering booking override payments (also known as Volume Based Incentive Revenue) to travel agents like CTD.

The question is should you worry about VBIR and how its booked.

Here's an extract from Travelport's 2018 10K (3rd largest GDS globally):

> "***Competition to attract travel agencies is particularly intense as travel agencies, particularly larger ones, have the ability to access content from a variety of sources, including subscribing to more than one GDS at any given time. We also have had to, and expect that, it will continue in certain circumstances to be necessary to, increase commissions to travel agencies in connection with renewals of their contracts****, which may in the future reduce margins. If travel agencies are dissatisfied with our Travel Commerce Platform or we do not pay adequate commissions or provide other incentives to travel agencies to remain competitive, our Travel Commerce Platform may lose a number of travel agencies."*
>
> (so bigger agencies, like CTD are getting paid **more per segment** over time and have gained real bargaining power…)

And from Amadeus's most recent results presentation (slide 10):

> *"Distribution: margin dilution mainly driven by a* ***unitary distribution cost expansion****, resulting from competitive pressure."*

(code for "we are paying large travel agents higher commissions per segment and we don't like it").

And from Sabre's 2018 10K (2nd largest GDS globally):

> *"Travel agency incentive consideration is a large portion of Travel Network expenses. The vast majority of incentive consideration is tied to absolute booking volumes based on transactions such as flight segments booked. **Incentive consideration, which often increases once a certain volume or percentage of bookings is met**, is provided in two ways, according to the terms of the agreement: (i) on a periodic basis over the term of the contract and (ii) in some instances, up front at the inception or modification of contracts, which is capitalized and amortized over the expected life of the contract.*
> ***This consideration grew in the double digits on a per booking basis in 2017 and 2018** due to higher incentives in certain geographical markets and from new customer conversions."*
>
> (So, the VBIR involves partial accrual and partial booking as earned, and its increasing on a per segment basis.)

CTD only started splitting out its Volume Based Incentive Revenue (VBIR) from 1st half 2018, but there is a very clear trend, and it mirrors our research findings:

1. Larger Travel Management Companies (TMCs) get better commission rates from GDS. We can see this in CTD's increasing VBIR yields (i.e. VBIR divided by TTV or total transaction volumes) and its confirmed by the GDS and other TMCs directly.
2. This revenue has *extremely high incremental margins*. CTD had to book the flight to earn the customer revenue anyway, so the only incremental cost associated with VBIR we can see is CTD measuring how much they think they're due. Pure margin!

So, if you're the 7th largest TMC globally, what might this mean?

a) The greater your booking volumes, the higher the rate of VBIR you are likely to get paid.

b) You might even use that to your advantage in bidding for work, so that it became a self-reinforcing positive.

Imagine, if you knew your percentage VBIR yield would increase if you won a contract and benefit all your future segment bookings across all of your customers. And that benefit only accrued to the top 10 TMCs and you were one of them. You could be fairly aggressive in your marketing pitch, because the step change in VBIR benefits might just offset the price haircut you took to win new contracts. Predatory pricing…done profitably.

That's pretty much what CTD, when you look at the time series yield on customer revenues vs VBIR, appears to be doing.

And if this benefit applies unfairly to the largest TMCs in the industry, you might even call it a competitive moat or competitive advantage. You might even be incentivised to keep acquiring organically and via acquisitions, to grow your TTV, drive down your net customer cost position and increase the returns in your business. Your moat grows as you scale.

Viewed through this lens, the whole TMC sector sounds like an M&A rollup runway.

Slide 9 of the 176-page short seller presentation lists CTD as the 7th largest corporate TMC. The top 6 TMCs which are larger are *all* privately owned, but it wasn't always so. Hogg Robinson to who we've spoken used to be a listed company before they were taken over.

In fact, 4 of the top 6 TMCs have private equity ownership and these entities don't appear to be shy when it comes to M&A.

This raises an interesting series of questions.

What if CTD isn't a screaming fraud and it isn't going to zero.

We can see in some of the data that there is a cyclical slow down-playing out in Asia; a slow-down appears entrenched in Europe. There is some cyclical earnings risk, but it's been apparent since calendar 2Q 2019. So, does it warrant a 47% price drop or is this in the price and then some?

Implicitly, part of the vocal short endgame was a de-rating of CTD which would make it harder for them to acquire smaller TMCs at accretive levels (assuming M&A target price levels don't adjust downwards which may be an heroic assumption).

Take away CTD's high multiple, take away their capacity to grow fast. Case closed. Or is it?

Because as a short seller you now need to be very careful what you wish for in a situation like this. Overstaying your welcome on a short trade can get painful.

If CTD isn't some massive fraud, but rather is plum in the middle of a sector being actively rolled up, when does CTD as the M&A hunter become the hunted?

We have initiated a position in CTD; we will look to add to it should the price drift lower.

Market view

Interest rates are the lens through which we see the financial future. Because interest rates are very low, the promise of growth stocks' far distant cashflows are highly valued right now by the market. These stocks might be viewed as expensive in an absolute sense and relative to most periods in their valuation history.

Growth stocks showed back in 4Q 2018 that they could fall 20% plus in a short space of time from their elevated valuation levels. So, there is an ongoing potential vulnerability to this type of short, sharp correction that we'd rather avoid.

Yet if interest rates approach or go below zero with central banks such as the RBA testing the lower effective bound, anything that can actually grow its earnings is likely to become exquisitely expensive. Stocks that are expensive today can easily get way more expensive if they can grow earnings and most other stocks have flat or falling earnings. We fear the possibility that longer term, deflation may await us all. And we've spent some time studying a few of the instructive analogues, such as Japan in the 1990s.

The collision of demographics where median age increases past some peak level of consumption propensity, coupled with an approaching end to the ability of central banks to cut interest rates, thereby boosting consumer capacity for more debt and more consumption, may portend deflationary risk.

In a deflationary world, value stocks get taken to the proverbial woodshed.

If a stock cannot grow its earnings, at best it offers the potential for a mean reversionary dead cat bounce. At worst such a stock is a value trap, locking the naïve into a trajectory of entropic decline. The saying goes "what's cheap can get cheaper" but perhaps some so called value stocks were never cheap, because if their earnings keep falling each year, they actually get more expensive over time relative to earnings.

So, our current approach is to hunt in areas which we think are less duration or rate sensitive for mispriced growth. These situations usually arise due to misunderstood business models or short-term problems that market participants choose to excessively extrapolate.

There is *always* opportunity; we just have to recognise it when we see it.

15 October 2019.

Geometrica Fund

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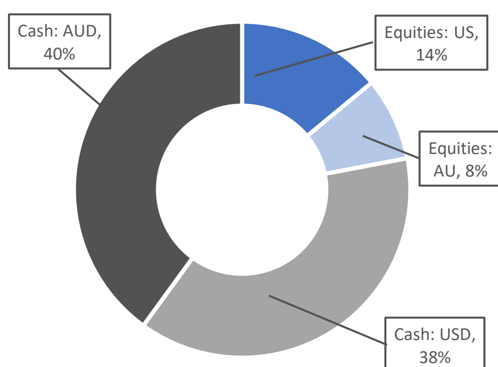
Fund Overview (Alpha Units)

Fund	Geometrica Fund	Investor Eligibility	Wholesale only
Structure	Wholesale unit trust	Minimum Investment	A$250,000
Mandate	Global long short Mid-cap focus	Fees	1.5% management (+GST) 20% performance (+GST)
Gross exposure range	0 - 200%	Benchmark	RBA Cash Rate
Net exposure range	1 - 100%	High water mark	Yes
Single stock long limit	15% at cost	Liquidity	Monthly
Single stock short limit	5% at cost	Admin & custody	Mainstream Fund Services
Buy / Sell Spread	Nil / 0.25%	Platforms	Ausmaq

Asset Allocation at month end



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