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**Tyro Capital Management 2019 Annual Commentary**

**General Thoughts & Musings**

Much has been said by various market commentators about the price levels of stocks, interest rates, market risk, and volatility. We do not feel we have much to add that would be original, so we will decline to comment on the market in that manner right now. That said, we do see some very important trends in the United States that we do not believe the market is pricing properly.

People Are Upset

It is uncontroversial to say the United States exists currently in an extremely polarized environment. Though political tensions flare, disagreeing with the behavior or views of individuals or groups is entirely unrelated to understanding the underlying drivers. We do not think enough attention is being paid to what is causing the current dynamic. There are real concerns at the heart of this polarization: principally, critical chokepoints culminating in American's inability to attain reasonable healthcare, housing, and education. These are issues we have been aware of as a society for some time, but they are here now and cannot be ignored further.

Echoes of Druckenmiller

While Alex and Dan were still in college at Notre Dame, legendary investor Stan Druckenmiller was conducting a college speaking tour regarding a thesis he had on "Generational Theft." Druckenmiller highlighted the relatively lower level of opportunity that younger generations have access to, largely to the benefit of older generations. The thesis made sense and its ramifications seemed inevitable, but also there was no clear timing on when these issues would surface. Just like the never-ending popular debate around Social Security, his thesis involved issues that would likely not come to a head for decades. Perhaps more importantly, there was clearly no incentive structure in place to generate a feedback loop to force a correction of any of these issues. In fact, the incentive structures present in the United States' economy and political machine drove feedback loops that would only grow the problems. Instead, the proverbial can is kicked down the road. Politicians want to get (and stay) elected and taking on tough issues and executing is more difficult than simply blaming the other side for being in the way.

This creates a vortex where these issues fester until the market provides a solution and, if that takes too long or is insufficient, the government will have to step in. Ironically, the government itself is one of the primary obstacles in these spaces. As the underlying issues begin to boil over, can-kicking becomes less and less tenable. In our view, housing, healthcare, and education are all rapidly approaching untenable circumstances. This is the driving force behind the urges toward populism and socialism, particularly in younger generations. People are perceiving a reduction in upside scenarios for their lives and the magnitude of downside scenarios is coming into sharper focus, leading each to blame the other side for creating this circumstance.

The media is a critical accelerant in all of this, with a vested interest in selling controversy to drive views and clicks, which is extremely lucrative. But over time, people respond poorly to this negative stimulus and are driven to blind tribalism. We observe increased polarization on all sides of the political spectrum. These issues are so inherently emotional that it is nearly impossible to have a reasonable conversation about any of these subjects with an increasingly larger percentage of people. The intense responses create an environment where people are trapped in a hall of mirrors in their own mind, and the country is in a vicious cycle of negative fundamental attribution. People who disagree with each other are quicker to say the other holds a view because they are bad people rather than because they have different experience sets and world views.

All of this has been true for some time, but now we are observing trigger dynamics to force confrontations:

Trigger #1: Affordable Housing

In 2017, we began to do a lot of work on housing, and, more specifically, affordable housing, which led us to some concerning conclusions. We found that the United States suffers from a critical, growing shortage of affordable housing. The National Low Income Housing Coalition estimates that there is a shortage of more than 7.2mm affordable and available rental homes for households in need (note: there are 2.5 people per household on average), and there is no state where a renter working a full-time minimum wage job can afford a two-bedroom apartment. According to a study from Harvard University, the stock of low-cost rental homes has shrunk by 4 million units since 2011. Other measures demonstrate this trend, such as the decoupling of home price growth and wage growth after 2000. In short, housing supply is not adequately serving housing needs.

This shortage has significant impacts on family formation and wealth creation for younger demographics, particularly millennials. Baby Boomers are living longer and more independent lives, soaking up more of the housing stock than previous aging generations. In addition, retirees often look to trade down to more modest homes, putting upward pressure on prices for lower-end homes. Millennials are having a difficult time finding homes they can afford, which stunts their ability to begin building equity in a home (the biggest wealth driver for most of the population), placing them behind older cohorts.

We are not in the business of predicting politics, but when we look at these numbers, it is clear that if the shortage of affordable housing is not addressed, it will force people out of desperation to become single-issue voters in elections. At some point, a politician will promise a solution, and they will win. We summarized our thesis and published a piece on the manufactured housing industry in 2017 and invested in some of the manufacturers, who have done quite well. Manufactured housing remains a long-term thesis for us.

Trigger #2: Healthcare

Premiums and deductibles continue to rise. Average premiums for family coverage have increased 22% in the last five years and 54% in the last 10 years, outpacing wages and inflation. Deductibles have increased, as have the number of people who have annual deductibles over $2,000. There are many Americans, particularly younger generations, making $35,000-$45,000 per year who are facing cumulative costs upwards of $5,000 per year before any insurance coverage kicks in. This is leading to more people not seeking treatment for serious but not imminently lethal health issues. Quality of care is also declining, as cheaper plans offer limited and inconvenient options.

Obamacare changed the landscape of healthcare but did not stem the issue of rising costs. There are many proposals and models that have been articulated by people on all sides of the debate; again, we are not in the business of proposing policy changes, but we can see how the issues are developing. When people are being crushed by costs and feeling the impact of how broken the system is, they begin to demand urgent solutions. This is, in our estimation, a big reason for Bernie Sanders's popularity. For many people in the Democratic Party, Medicare for All is enough to roll the dice on a Sanders nomination. This also partially explains the steep decline in Elizabeth Warren's poll and betting market numbers, as she backed away from the Medicare for All platform after detailing a $20.5 trillion price tag for the program. It is very much worth noting that Warren's polling metrics peaked immediately following waffling on Medicare for All, and Sanders's metrics continue to rise despite opposition from the DNC itself – very reminiscent of Trump's 2016 primary polling performance.

Though the government already spends an enormous amount on heath care and is deeply intertwined with the industry bureaucracy, there is a sense the free market has failed (or shouldn't be a driving force in healthcare to begin with). This leaves the government as the lone solution in the eyes of more and more voters.

Trigger #3: Education

Higher education is getting more expensive. The average cost of a four-year degree has more than doubled in the last 30 years on an inflation-adjusted basis, outstripping wage growth. Students have covered those increased costs by taking on loans. ~18 million students in the US attend college each year, with as many as 70% borrowing to cover tuition. Outstanding balances of student debt have exploded to over $1.5 trillion – nearly 7% of GDP (up from 3.5% of GDP in 2006). The average 2019 undergraduate student graduated with $20,600 in student debt, including those who did not borrow. Excluding non-borrowers, the average climbs to $29,900 per borrower. This puts new graduates in the hole financially before they even begin their career.

Meanwhile, college enrollments have decreased, with total postsecondary enrollments down 1.3% year over year in fall 2019. Undergraduate enrollments were down 1.7%, while graduate and professional programs saw a 0.8% increase. Total enrollments are down 2 million from a 2011 peak. There are several reasons for this decline: skepticism about the value of a college education, a shrinking population of high school graduates, and yes, concerns about cost.

On the other hand, it has gotten much more difficult to get into top-tier schools in the last 20 years. For example, acceptance rates at Stanford and Harvard have fallen from 15.5% and 12.3%, respectively, for the class of 2001 to 4.7% and 5.2% for the class of 2021.

Costs are rising, driving higher student debt burdens, and getting into a good school is becoming more competitive. At the same time, recent college graduates (defined as ages 22-27 and holding a bachelor's degree or higher) are more likely to be underemployed or unemployed than overall workers for the first time in over 30 years. So, you have a system that's expensive, requiring an enormous toll to get through, leading to significant debt, and is competitive and less effective at helping students achieve gainful employment. It's easy to retort that graduates who are unable to get work simply majored in the wrong thing, or that they shouldn't have taken out loans they couldn't afford with the degree they pursued. But that doesn't solve the problem for graduates who are struggling, and this is leading them to look to anyone offering to throw them a lifeline.

**Implications**

Four Big Risks

The correct course of action given all of this is not to retool our investment program, but to simply remain disciplined and consistent in our process with an awareness of the ways we expect the future to get… weird. To that end, we see four high level categories of risks:

- Tribalism: The mass shift from groups acting in self-interest to acting purely out of spite and hatred for "the other." This is how terrible societal decisions are made and how political systems fail. The Left vs. Right hatred in the United States is not making any progress toward actually addressing issues.
- Market Complacency: None of these risks have yet to intersect with markets – they inevitably will. The question is when, and the timeline has changed from a very vague "long-term" risk to the frequency of current political cycles.
- Execution Risk: Even if the core issues are addressed in concept, execution risk is enormous, especially when there are elections every two years. Even if government and industry were to both earnestly pursue broad reforms, the downside of failure or delays is immense.

- <u>Geopolitical Implications:</u> Globally, everyone else knows all of this, partly because they are experiencing it themselves, making the United States increasingly vulnerable on multiple fronts.
    - There is a very real question of whether a sophisticated democracy that intrinsically is unable to respond to issues efficiently can co-exist with social media.
    - Populism is driving a very noticeable search for "strongman" leaders.

<u>Opportunities</u>

- <u>Dispersion:</u> Very well-defined cohorts of the economy poised to outperform or underperform based on these underlying drivers.
- <u>Risk Management Is Cheap:</u> It is very cheap to hedge these risks, as they are not yet priced in.
- <u>Market Structure Flaws:</u> Psychological, liquidity, and market structure set-ups will produce opportunities of which we can take advantage. This was the focus of our last two quarterly letters.

**Lessons Learned**

The end of July 2020 will mark five years of operations for Tyro. We have learned many lessons in that period, but one stands out: **slow down**. We continue to find that gripping the bat a little looser and waiting for our pitch drives a more efficient process, better risk management, and ultimately better results. It is too easy to want to know, react to, or have opinions on an endless number of issues. Both the market and the media are tremendously skilled at tricking the brain into making these mistakes, and they get many market participants into trouble. Avoiding these traps and maintaining psychological stability is paramount. So much discussion is centered around the competitiveness of the stock market, but at the same time nearly every major downfall in money management has been an internal mistake. More often than not, the only person you are really competing with is yourself. At a fund level, improved returns are often driven by reducing losers more than increasing winners. By sitting back, not trying to force things, doing good work, and waiting until things really line up, we have been able to lose less, lose less severely, and better capitalize on opportunities to win. With years of research on file, we have the tools at our disposal to succeed or fail based on our use or abuse of them. The best way we can proactively work to ensure we do not abuse them is to deeply understand how fundamental investors can lose.

The most famous way fundamental investors meet their demise is via a single massive loss where they are unable to acknowledge the market telling them that they are wrong. They swing for the fences and end up falling on their own swords. It is a Greek tragedy that plays out nearly every year. We think there are a few things that can be done to eliminate that possibility. For one, even though we like concentrated positions, no one position should ever be large enough to sink the portfolio. We may have tremendous conviction in our thesis, but given that our job is to have at least several theses where we have conviction, we do not think we have an intellectual, ethical, or fiduciary right to risk blowing a permanent hole in our partners' capital over a single one. Position sizing is far more important to survival than idea quality, and we can still run sufficient concentration to produce robust returns without risking material impairment.

To further control capital impairment risk, we need firm mechanisms in place to offset potential blind spots in our own investment psychology. We have found that maintaining thesis reasoning in explicitly falsifiable and quantifiable parameters helps greatly, as it makes us unable to quibble about reasoning when situations become ambiguous. But more valuable, we have found consistently benchmarking theses against both what is in the book and theses we have in which we are not currently invested can be powerful. Humans are novelty seeking primates, and we can fabricate interest in subjects and lose context. Forcing ourselves to compare a new idea against all other currently implemented and potential ideas forces far clearer context with regards to the merit of an idea. Much of risk management ends up being a simple realization that an idea with which you may agree is structurally inferior to your other ideas.

**Thoughts on Active Management**

Given the popular sentiment that active management, and long/short equity in particular, is dying, we think it is worth the time to step away from our normal fundamental discussions and talk about what fundamental managers have done wrong to earn their current reputations, and what we can do to take advantage.

<u>Systems Don't Step on Rakes</u>

Quantitative and index investing, the two boogeymen of fundamental managers, are both subsets of systematic investing. So – at a high level – why do fundamental managers struggle to compete with systematic strategies? The advantage of systematic investing is not that the investment program is a better winner; it is actually a better loser. It loses less frequently, with less severity, and often with a superior tax profile, and that compounds over time. Certain systems are also designed such that if a particular type of return is available, the system captures it with near 100% certainty. In short, systems are consistent, their mistake types are known in advance and evaluated for tolerability, and the situations they will profit in are well understood. Systems are rigid, they do make mistakes, and they do miss things. But that does not matter because on a cumulative basis the results are good.

Discretionary fundamental managers, on average, are the opposite of this: making varying mistakes of varying severity, and inconsistently able to capture upside scenarios. It is not the case that fundamental managers cannot add value; indeed, many do. So, what makes the difference? The elephants-in-the-room are the massive psychological and behavioral traps in discretionary fundamental investing that sabotage most market participants – we would argue regardless of their resources – in attempting to deploy a fundamentally-oriented strategy.

<u>Views on Capital Flows and Price Are Mandatory</u>

At the most abstract level, it is important to understand that capital flows dictate price movements in markets. As an investor, you have three principle options to capture price movements and drive returns: (1) agree with a trend of capital flows (momentum, trend following), (2) disagree specifically with an instance of off-trend changes in capital flows (value, mean reversion), or (3) bet that flow trends may change (short-selling, hedging). Discretionary fundamental managers definitionally try to make money via one of the three options above allegedly based on fundamental research alone. But in order to make money (assuming they are not gambling), they must actually have both a fundamental view and a pricing view. If active managers have insufficient information or conviction in either view when they make an investment, they face two major risks: (1) being wrong and losing money or (2) being unable to have the emotional fortitude or structural ability to hold the position when prices move against them. Many famous firms and fortunes have been built or lost due to these issues. Fundamental managers should essentially be looking for both abnormal quality and prices in underling businesses, but that is not enough. Managers must also consider the primary driving variables of the market and avoid falling into psychological traps of perceived stylistic purity.

<u>Not Liking a Bet Is Not an Excuse for Making Even Worse Bets</u>

A dynamic we see repeatedly is the behavioral cascade impact that up-trending markets have on money managers. Value managers, which is a label we would apply to ourselves, attempt to buy securities at a discount to intrinsic value. The problem here is that so often when the stock market goes up, value managers, as a class, tend to stop doing serious research on businesses because they see prices going up and assume there are no bargains to be had (the "I missed it" phenomenon). They focus on the small percentage of stocks that are down (or haven't appreciated) and look for bargains there, often losing money because the quality of the cheap business was low for a reason.

The fundamental error in defaulting to low valuation instead of deep fundamental underwriting work as a top-of-funnel screen is best explained if one were to imagine the stock market as a retail store. You speak to the salesperson and they say to you, "OK, we have 1000 different things you can buy. These 800? They're all the same price. These 100? They're super nice and very expensive. Finally, we have these 100 that no one wants. They're very cheap." Now, imagine after that he told you, "Oh, and a thousand people already picked through the cheap ones."

1) The intuitive belief in value is that due to the cheapness of the stocks, the level of evaluation quality necessary to gauge risk is lower. This may have made sense in the pre-digital era, or when buying cheap stocks was not popular and carried career risk, or before the proliferation of numerous, massive private equity firms with incredible resources and incentives to buy any business that actually was cheap. Does the bottom bucket approach really make sense anymore in liquid markets? Everyone on planet earth with an internet connection sees the bucket of 100 cheap companies and they remain cheap. Cheap stocks are not dogs anymore. They have neon signs over them and annual conventions celebrating their virtue.
2) We assume quality differences between businesses exist. Does it really make any sense that the 800 businesses in the OK cohort are priced the same? Does it make more or less sense than the basic claim that 10% of businesses are likely very good or very bad?
3) When low multiple stocks make money, more often than not it is driven by sector flows or some sort of insider activity.

In our view, value managers often end up with an adverse selection problem in addition to the same capital flows exposure that other managers have, effectively increasing risk in exchange for psychological comfort. At Tyro, we find research indicating a price is incorrectly calculated to be far more valuable than research indicating a price is too low. This is because if the research is correct, you generate a return from the price being corrected and then typically you observe a shift in capital flows on top as an increasing number of investors realize the underlying security is of good quality.

Don't Let It Get Personal

Managers who are dogmatic and eschew securities outside of an overly rigid definition of their style inevitably form emotional and psychological issues as they underperform ("The people making money right now are hacks! This will end badly! These companies are fads!") or outperform ("I showed those fools! No one listened to me and now they are getting what they deserve! I'd never buy XYZ at any price!"). Instead of viewing the market rationally, they have developed an adversarial relationship and association with certain types of investments and investors, definitionally limiting their opportunity set. It is worth noting that very few of the money managers who made immense sums of money prior to the 2008 financial crisis would listen to bearish views as it approached, and very few money managers who made immense sums of money in the crash have been able to make any money since, largely due to psychological anchoring. And then there's David Tepper. He owns an NFL team now.

Anchoring also causes many managers to lose nuance in their evaluation. When a business is considered to be very expensive – even if it is truly a great business – most value managers are unwilling to buy it when it corrects to a valuation level close to the broad market averages. They often want to buy it at the valuation multiples of lower quality companies they already own, which means they never get to buy the high-quality company. But it also shows a misunderstanding of flows, which structurally will always prioritize a reasonably valued high-quality company over an esoteric small cap sum-of-the-parts thesis when the market is functioning well. If the market is not functioning well, both securities will be slaughtered. The reason for this at an intuitive level is the market is more comfortable underwriting the high-quality company.

Underwriting Edges Are Real, Valuation Edges Are Not

The key difference between early value investors and current fundamental investors is a belief in one's ability to underwrite investments. We do not see a role for managers who cannot seriously underwrite investments and simply seek to buy cheap securities given there are far too many systematic strategies that will do the job sufficiently well and with sufficiently low fees to make the offering obsolete. These dynamics are not unique to fundamental managers. Many purely systematic managers have faced similar issues over time as their strategies have become better understood, replicated, and commoditized.

Weak Hands Produce Opportunities

The broad commoditization of the investment space has led to increased agency costs borne by the market in short intervals. Clients are far more critical of their money managers and even legends in the business have been forced to close their doors as clients pull out over lackluster returns or a belief that the manager's services are undifferentiated. This means most money managers do not have the structural ability to take as much risk or ride out volatile bets as they did before. This in turn reduces money manager returns and causes money managers to cut back their positions far more aggressively when things are not going well, thus creating short-term price distortions. Thinking predatorially, money managers operating obsolete strategies can be sources of great investment opportunities when their clients redeem and force them to exit positions.

Investing is a very difficult and complex game, and many money managers will lose regardless of style. The opportunity lies in expanding one's skillset from purely fundamentals to understanding how and why other investors lose and using these structural factors to determine how to allocate capital based on fundamental views. In poker terms, one needs to know the quality of a hand (fundamental views), positioning and the texture of the board (flows, pricing views), and how the weaknesses of other players will allow you to profit from that information (structural inefficiencies). Below are a few elements of how we think we can use process to execute.

Research: Building vs. Digging

If a manager spots a cheap stock (pricing view) and reads up on it, no one would disagree that the work may or may not amount to anything of value. What is rarely discussed is that the real expected value of random stock research is zero (setting aside abstract arguments advocating for studying a thousand random things and hoping in the end they come together to drive some insight). It is likely even negative when adjusted for time and opportunity costs. There is simply no evidence or logic to thinking there is a strong fundamental view to be had on a random stock on a random day.

Conversely, if a manager allocated research time based on what industries and themes very likely will accrue significant economic value over the long-term (fundamental view), the research becomes an asset that is monetizable repeatedly any time price offers an opportunity. Fundamental views change very slowly in comparison to price views, which change by the second. Furthermore, the knowledge here of both the underlying and the pricing dynamics compound over time.

Research should be done based on what is worth knowing over time, not based on what may be actionable today. This is the core of our process at Tyro. But how does one develop a pricing view?

Factors Are Your Friend

If the entire market is moving up or down at once, is it really telling you anything about an individual company? Probably not. If all small caps are moving up or down at once, is the market really telling you anything about an individual company? Probably not. If an industry is moving up or down at once, perhaps it reflects actual issues in the industry, but does that necessarily reflect every company categorized by index providers as being in that industry? Probably not.

If an individual company or cluster of companies is moving up or down at once, does that imply more or less information about the underlying versus the market or sector moves? Also, what is the probability that localized moves in smaller clusters are driven by a small cohort of market participants having to adjust their ownership? Can this be evaluated? Absolutely. It is very difficult to evaluate and predict broad investment capital flows. Some may be able to do it, but it is objectively much easier to evaluate and predict specific market participant groups' capital flows.

Psychological & Social Bias Structures

**Social Cost Arbitrage:** Don't forget the pecking order.

- Micromanagement: At the firm level, active managers increasingly have to justify individual positions to LPs, meaning investments not only have to be attractive to the manager, but also saleable to the client. Depending on the biases of the clients, managers may be unable to take advantage of insights because they risk losing clients.
- Boss Bias: Managers may have concerns with or even obsessions about a particular issue (election risk, fed balance sheet, etc.) that put employees in a bad spot because they will get fired if a particular investment does poorly around that same time that the issue manifests. Employees will not escalate ideas that they know go against their boss's biases.
- Boy Who Cried Wolf: Individuals inside institutions generally cannot escalate views that have been escalated previously multiple times, even if the conditions for a good investment were not met in prior iterations. Managers scoff at pitches they have heard before.

**Armchair Quarterbacking:** When looking at a business or industry it is very important to ask "what is actually in play?" rather than what one thinks should be happening. Are management teams in the space acting with specific intent and executing? Investors drum up theories of management execution, M&A, customer trend shifts, or other dynamics when in fact the given company/industry is not seriously considering anything of the sort and the management team has explicitly stated such.

**Flawed Narrative Extrapolation:** Often the market forms narratives that begin quite reasonably and become completely deranged over time. Observing shifts in theses of other investors until they become ridiculous can provide excellent opportunities if a catalyst can be found to correct the fallacies of a given thesis. We would note this is far riskier to execute when attempting to short sell than when attempting to go long. Short positions do not work when short sellers are proven right. They only work when longs admit they are wrong.

**Mental Benchmarking:** When a stock corrects, investors mentally benchmark to some historical price or other market valuation regime and miss great entry opportunities. Particularly for high quality companies, a non-trivial relative valuation discount is more valuable than a valuation that could be deemed "absolutely cheap" for a subpar firm.

**Phantom Catalysts:** Occasionally, one is able to identify a potential event where either nothing will happen, or something favorable to a specific position will happen. These are typically industry events the street is not following or technical details deep in company filings that provide a certain date for things such as a credit event.

**Price Insensitive Actors:** Investors and LPs often expect a fundamental, company-specific reason for stock price movement, but generally there isn't one.

- Passive Flows: Mutual funds, ETFs
- Active Flows: Hedge funds, mutual funds, secondary sales
- Quant Flows: Model-based position requirements
- Mandate Restrictions: Size restrictions, liquidity restrictions, concentration restrictions, de-listings, headline risks, ESG

**Flows Analysis:** As discussed above, factor basket flows can be used to determine where more or less security specific information is likely to be priced into individual stocks. It is important to note that this is not statistically significant over short time horizons, but over longer holding periods the compounding effect of a lower cost basis in an outperforming name is disproportionately valuable. In the short term, when factor baskets bottom there is often a "dash for trash" where lower quality or lower liquidity names outperform. This can be frustrating both on the way down and the way up, causing bad decision making.

Our strategy has been and continues to be to look to avoid and counter punch against these dynamics.

## Portfolio Update

Current Holdings

**Long: Altria (MO)**

MO, a position we initiated in Q3, is an example of being able to take advantage of dislocations resulting from market overreaction to flawed narratives. The stock had been plagued by alarmist headlines about the safety of JUUL, in which MO had taken a significant stake, and, with some accelerant from the ESG push, dumped the stock to levels that priced the business such that JUUL, Chronos, the minority stake in AB Inbev were all valued at zero and the core business was valued at an impaired level. To us, this was a clear overreaction, and the market offered us the chance to take a position in one of the highest quality sources of yield in the equity market in a market starved for yield.

We continue to hold our position in MO (via stock and options), as disclosed in our previous quarterly letter. The stock was a substantial contributor to our Q4 and we remain bullish. The stock is still cheap by any metric: a forward dividend yield north of 7%, a forward FCF yield near 9%, and a P/E of 10x. We do not need any upside from MO's stakes in Chronos, JUUL, or AB InBev for this to be a successful investment. The cigarette business will continue to decline at a relatively predictable rate for years to come, with volume declines offset by price increases, and the company will throw off mountains of cash to be returned via dividends and buybacks. Given our strong dividend yield on cost, we are inclined to hold the position for the long-term, absent the market offering us a premium price at which to sell.

**Long: Recro Pharma (REPH)**

We have followed the REPH situation for several years and it had been a "boy who cried wolf" situation since the company IPO'd. The company had two businesses: a drug development franchise focused on acute care and a pharmaceutical manufacturing business known as a contract development manufacturing organization (CDMO). For many years, the profits from the CDMO business subsidized the acute care segment, which was focused on the development of intravenous meloxicam (IVM). The development of the drug was troubled, to say the least, with the company receiving two complete response letters (CRLs) from the FDA regarding the IVM NDA, the second of which was received in March 2019. The common long pitch for the stock was always that the two businesses would be separated, unlocking the value of the CDMO, but management showed no indication of taking that path until the CRLs.

Following the receipt of the second CRL, an activist (Engine Capital) joined the board of directors and the company charted a course to spin off the acute care business from the CDMO while cutting development expenses associated with IVM. The spin, ideally, would unlock the value of the CDMO, which had been masked by losses associated with acute care.

The spin finally happened in Q4 2019, with the acute care business now trading as Baudax Bio (BXRX).

On a standalone basis, the CDMO can do ~$60mm in EBITDA for 2020. At a 15x multiple (based on transaction comps), that implies an EV of $900. Bridging that back to an equity value (adjusting for REPH's $19mm contribution to BXRX) of $622mm yields an implied share price of $30, offering considerable upside from the current trading price of $16.55.

As a footnote, the FDA granted BXRX an appeal on the CRL issued and scheduled a PDUFA date for February to render a judgment on IVM, so there is still a chance for IVM to be approved. We still hold the shares we received in the spin, which could further enhance the return on the overall investment.

**Long: Skyline Champion (SKY)**

After a rough back half of 2018, SKY stock had an excellent 2019, returning over 115% during the year. We continue to hold a position in the stock, although we have taken some profits to rebalance the portfolio.

The underlying business is continuing to perform to our expectations, even as the broader industry grew more slowly than we expected in 2019, with US industry unit shipment growth inflecting upwards into the back half of the year after facing difficult comps in the first half. All the fundamental industry tailwinds we have called out in past letters remain intact, including base demand from aging-out, new demand as alternative to site-built for millennials and retirees, use of manufactured units in new developments, and an improving regulatory and credit environment.

One development we'd like to highlight is SKY's new product line under the Genesis brand, introduced in October 2019. The Genesis line offers affordable single-family homes targeted at builders and developers looking to leverage off-site building. Homebuilders are increasingly looking to manufactured housing and off-site construction to control costs (particularly labor) and project timing. For example, Pulte CEO Ryan Marshall indicated on their Q3 2019 earnings call that off-site building would be a significant opportunity for his company going forward. SKY is well-positioned to capitalize on this opportunity, which could contribute to significant unit volumes in the coming years.

Management has continued to deliver strong results, driving margin improvement and generating strong cash flow. At the time of writing, the company has an enterprise value of ~$1.6bn and trades at 11x consensus F2021 EBITDA, while peer Cavco trades at 15.2x. At parity, SKY would trade at $40.

**Long: Super Micro Computer (SMCI)**

Our initial investment in SMCI was a textbook example of taking advantage of a position unwind. Several factors contributed to the steep selloff that drove the stock to its October 2018 lows, where it touched $8.50 per share, down from $21.50 at the start of the month. The company had fallen behind on its SEC filings due to an ongoing restatement process and had been de-listed from the NASDAQ in August 2018. The combination of these circumstances, along with the discredited October 2018 Bloomberg piece alleging that SMCI's chips were compromised by the Chinese government, drove the stock to levels that were far outside of a reasonable valuation band. We were able to step in and buy.

SMCI hit an important inflection point in Q4, finally completing the restatement of their historical financials and getting current with their SEC filings, paving the way for the stock's re-listing on the NASDAQ on January 14, 2020. At the end of their fiscal Q1 (ended September 30, 2019), the company had net cash of $217mm, putting the current enterprise value at $1.2bn. Even with the accounting issues behind the company and the stock back to trading on a major exchange, it remains extremely cheap at just ~11x LTM adjusted EPS.

The underlying business is performing well. Management raised revenue guidance in the press release for the re-listing and the headwind from the restatement and audit committee investigation (a $56.9mm expense in fiscal 2019) will be gone moving forward. On the technical side, we see the potential for some forced buying in the coming months as the stock gets added to indexes now that it is no longer trading OTC.

New Positions

**Long: Ubisoft Entertainment (UBI:FP)**

We are generally bullish on the video game industry and believe it will benefit from significant tailwinds for the next decade and beyond as the entertainment industry transforms. At present, we are long shares of Ubisoft Entertainment, the studio behind popular gaming franchises *Assassin's Creed*, *Far Cry*, *Just Dance*, *Prince of Persia*, *Rayman*, *Raving Rabbids*, and *Tom Clancy's*. UBI shares trade at a steep discount to peers. We believe this discount is unwarranted, reflecting near-term concerns around the poor critical and commercial performance of *Tom Clancy's Ghost Recon Breakpoint* and, to a lesser extent, the underwhelming sales of *Tom Clancy's The Division 2* and three release delays that will only impact the current fiscal year (UBI has a 3/31 fiscal year). These delays were partially informed by the performance of *Ghost Recon Breakpoint*, which drove a re-evaluation of internal development processes. It should be noted, however, that UBI has had significant recent success and there is no reason to believe that the development process or IP at UBI is impaired. This is likely a one-off, in our view.

The product delays set up for a strong fiscal 2021, with UBI set to release five AAA titles into a refreshing console cycle, with the Sony Playstation 5 and Microsoft Xbox Series X both releasing later this calendar year. Management has pushed back against the notion that F2021 could be a near-term peak, pointing out that F2022 will feature the release of an additional 3-4 AAA titles on top of the back-catalog form F2021. We would not be surprised to see management further re-shuffle the release schedule, perhaps to smooth out the pacing between F2021 and F2022.

UBI trades at an EV of €8.3bn, 7.3x consensus F2021 EBITDA. Meanwhile, Activision Blizzard trades at 16.8x 2020 EBITDA, Electronic Arts trades at 15.6x, and Take Two trades at 17.4x. On a P/E basis, UBI trades at 19.0x consensus F2021 EBITDA, while Activision Blizzard trades at 24.2x 2020 earnings, Electronic Arts trades at 23.0x, and Take Two trades at 25.5x. On a five-year average basis, UBI has traded at an EV/EBITDA of 14x and a P/E of 24x, which would imply share prices of $126 and $82, respectively. That's a pretty wide range, and the we think the ultimate outcome is likely somewhere in the middle, offering an attractive return from current prices.

**Long: Match Group (MTCH)**

As those who have followed us for the past three months are aware, we are very bullish on the long-term prospects for the online dating market (our published research piece can be found here). We had previously been long Match Group via parent company IAC (no longer in the portfolio) but were presented with the opportunity to build a position in MTCH directly at a very favorable price when the stock sold off hard following the release of its Q3 2019 earnings. We knew the selloff was an overreaction – the quarterly results were fine, and nothing had changed with the long-term prospects of the business.

MTCH is the best way to directly get long the trend in online dating in the public markets (putting aside playing the spin-off via IAC). MTCH owns a portfolio of brands in the online dating space, including Tinder, Match, Hinge, Plenty of Fish, OkCupid and more. As of Q3 2019, MTCH had 9.6mm average subscribers monetizing at an ARPU of $0.59 per day. The company generates substantial cash flow, converting EBITDA to FCF at a rate of 87.5% in 2018. In Q2 2020, IAC will spin off its ~81% ownership in MTCH to IAC shareholders in a tax-free transaction. MTCH will be recapitalized, assuming certain debt from IAC, completing the spin 4.2x pro forma net leverage, which the company projects to reduce to under 3.0x by the end of 2021. Given that the company was able to reduce its leverage from 4.1x at Q4 2015 to 1.7x at an LTM basis at Q3 2019 (while also returning $1.2bn via buybacks), we are confident that the business will be able to de-lever rapidly going forward.

Using the pro-forma capitalization for the spin, MTCH is trading at ~29x consensus 2020 EBITDA. This multiple may be eye-watering, but we take a broader view of the business's long-run opportunity. Estimates suggest there are as many as ~700mm online singles worldwide. Smartphone penetration is accelerating globally. The total addressable market is vast and growing, and MTCH is positioned well to set itself up as a dating toll road. ARPU has been growing at a solid clip, driven by a 74% increase in Tinder ARPU from Q3 2016 to the most recent quarter. We believe MTCH has the capability to drive ARPU growth through the continued buildout of add-on and premium features across its platforms as it has with Tinder Plus and Tinder gold. Even more interesting to us is the possibility of MTCH expanding its app capabilities past the initial match stage to capture dating spend more broadly (dining, entertainment, etc.). The partnership between Hinge and OpenTable announced last October is an indication that MTCH is thinking along these lines. Best of all, the company can add features on a test basis in local markets to evaluate effectiveness, rather than doing a sweeping update that could disrupt the user experience. We can envision a future where restaurants and bars are eager to partner with MTCH to drive in-store traffic, even if that means sharing on some of the economics.

To try to understand how the market is valuing MTCH, we reverse-engineered a DCF to generate the current share price. We were able to get there with 10-year projections that had the company hitting just under 20mm subs at a $0.61 ARPU in 2030 with a bit of margin expansion and a 3.5% terminal growth rate. We think the subscriber and ARPU figures we used are extremely conservative, given the size of the market and MTCH's position. We believe the forward return prospects for the stock remain attractive at its current price.

Exited Positions

**BlueLinx Holdings (BXC)**

Not every investment worked in Q4. BXC was a notable loser for the fund. We discussed the thesis in past letters and would like to share some brief thoughts on what happened with the business and why the investment didn't work.

In a nutshell, the thesis with BXC was that the company, post-merger with Cedar Creek, would be able to achieve synergies from scale benefits and, coupled with harvesting cash from its real estate portfolio, generate significant cash to de-lever the balance sheet and provide substantial returns to the equity. We believed that the housing market would be strong enough to support this transition.

A few things went awry. Lumber prices sunk after a huge run-up through mid-2018, which hit BXC's margins. More importantly, BXC experienced merger dis-synergies with its supplier base, with some suppliers walking away, resulting in market share erosion. We had been aware of some supplier loss, but the impact was beyond what we had anticipated. The company reported an abysmal Q3, causing the stock to crater. While the company may ultimately be able to sort these issues out, the business carries a substantial amount of leverage and has yet to generate the levels of EBITDA – let alone free cash flow – that we had hoped to see. Furthermore, the company is going to have to spend more on SG&A going forward than originally contemplated to stem the loss of suppliers and regain market share. We sold the position at a loss.

**Myovant Sciences (MYOV)**

This investment was predicated on a phantom catalyst – we believed the behavior of Sumitomo Dainippon Pharma following the acquisition of their stake in the company presaged either positive clinical data or a takeout of the remaining common shareholders. It struck us as a one-sided bet.

We have followed the "Vants" – a family of biotech companies started by Roivant Sciences – for several years. While there is a long backstory to how these companies came to be, what is relevant is that this trade is reflective of how we warehouse our research in the biotech field and are able to deploy it opportunistically when special situations arise.

We initiated the position in MYOV in September alongside a position in Urovant Sciences (UROV), which focuses on urologic conditions, following the announcement that Japanese company Sumitomo Dainippon Pharma would be acquiring 46% of MYOV from Roivant (their entire stake) along with Roivant's 75% ownership in UROV, 3 other private "Vant" entities, and 10% of Roivant in an all-cash transaction valued at $3bn. On the day the transaction was announced, MYOV traded at $7.51 per share ($675mm market cap) and UROV traded at $9.99 ($300mm market cap). Combined, the market value of Sumitomo's stake was $536mm. Sumitomo did not give a breakdown of the purchase price allocation and has yet to do so, but did indicate that MYOV and UROV were considered to be more valuable than the other companies acquired. Of note, they acquired 100% ownership in the other companies. Allocating the purchase price at equal weight (inclusive of the 10% stake in Roivant) suggested that MYOV and UROV were worth a combined $1bn. Moreover, we judged it likely that Sumitomo would eventually seek to consolidate the public companies entirely and buy out the remaining shareholders. On a combined basis, it appeared that we could arbitrage the situation and buy MYOV and UROV at roughly half of what Sumitomo valued them.

In the aftermath of the transaction announcement, MYOV stock declined, continuing a downward trend it had been on since peaking at $25 in April 2019. We added to the position gradually, eventually building it to 3.5% of our capital by the end of October at a basis of $5.28 (UROV was a 3.2% position at the time).

In early November, Sumitomo announced they were providing MYOV with $350mm in non-dilutive financing to support commercialization of relugolix, its lead candidate for treatment of uterine fibroids in women and prostate cancer in men. Sumitomo also planned to provide MYOV with a priority review voucher to help accelerate approval. We viewed these developments as overwhelmingly positive, given that Sumitomo chose to offer financing in excess of the value of their 46% position at the time of the transaction announcement. Moreover, this came in advance of an important data readout for a phase 3 study evaluating relugolix in men with advanced prostate cancer.

On November 19th, MYOV announced positive data for that phase 3 study, sending the stock as high as $17.17 vs. the prior day close of $6.06.

**Firm Updates**

As mentioned in our last update, in November we launched an online presence for the fund, including a website, Twitter page, and non-stock specific published research. Our first published piece details our view of the Online Dating Market. The paper went viral and was picked up by several media outlets including Institutional Investor, The Financial Times, Bloomberg, Marginal Revolution, and others. We are thrilled with the positive response. Tyro will be publishing additional broad thematic pieces in the future.

A logical question for current and prospective LPs to ask is "why would a hedge fund publish a piece like this?" It makes sense to ask, particularly given the historical reputation of hedge funds being tremendously secretive.

The main reason we wanted to publish was to test a hypothesis. The internet is unquestionably the greatest information tool ever created, and on the internet, Twitter has become a hub, if not the only hub, for information globally. With over 330 million users, pretty much everyone in developed markets is either on Twitter, or knows someone who is on Twitter. In information-based fields (finance, technology, healthcare, journalism) the penetration rate is staggering. Even if senior decision makers do not use the platform, often times their entire teams do.

We believe there exists an untapped ability to conduct mass market distributed research and identify more key opinion leaders (KOLs, aka smart people with insight) through a transparent online publishing model versus through traditional methods (conferences, expert networks, etc.). This can only be done by someone who has built a large following online and who has a generally good relationship with the online community, something we have developed over the last several years, initially due to lack of resources during our start-up phase. Now we can use this as a very powerful research tool. Obviously, the average person on the internet does not have much of value to say, but let's assume 1% of them do. If we can put out work on themes and areas we are interested in and attain viewership in the hundreds of thousands, we can actually scale information gathering and collaborative insight fairly efficiently.

Our first paper was clicked on over a million times and resulted in several dozen in-bounds to Tyro from people in academia, industry, start-ups, and other fields who have done research on the dating market and wanted to share insight, collaborate, or debate. Even more have begun sending us any and all research they see on dating, beyond what we could track internally (which is already quite a bit). It is important to note that what we do not want to do with publishing is make specific stock picks. Doing so would invite compliance headaches but more importantly would implicitly or explicitly require us to time our research with day-to-day stock prices, as research would be judged based on short term returns on the related securities. We do not want internally or externally to have our research process correlated with current stock prices or current views on stock prices. What we want is to develop key insights into markets so that we can deploy capital later should pricing provide an opportunity. From this perspective, the distributed research effort has thus far been a monumental success, and we look forward to continuing to test it.

With warmest regards,

Daniel McMurtrie

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