River Oak Capital

# 2020 Letter to shareholders

## Disclaimer

*This letter is not intended for public use or distribution. It is not to be reproduced or redistributed in whole or in part without prior consent of River Oak Capital AB ("the Company"). You agree not to copy, modify, reformat, download, store, reproduce, transmit or distribute any data or information contained herein or use such data or information for commercial activities without first obtaining written permission. The Company has sole ownership of the data and information provided.*

*All data and information is provided "as is" and is for private use only. It is not intended for trading and does not constitute advice on investments, securities, taxes, law, accounting or anything else. The Company does not advise on investments or your finances. No data or information constitutes investment advice or a recommendation by the Company to buy, sell or hold any securities or financial products, and the Company makes no representations about the suitability of any investment.*

*This letter does not constitute an offer or solicitation to invest in the Company or an offer or solicitation for any other investment products or investment advisory services. In making an investment decision, investors must rely on their own examination of an investment and make an independent determination of whether an investment meet their investment objectives and risk tolerance level. Prospective investors are urged to request any additional information they may consider necessary or desirable in making an informed investment decision.*

*The author has to the best of his/her knowledge tried to gather correct information but there might still be factual errors present. The Company and its affiliates (A) expressly disclaim all responsibility for the accuracy, adequacy, or completeness of the data and (B) shall not be liable for any errors, omissions or other inaccuracies, delays or interruption of such data or for any action taken on the basis of trust in it. The Company shall not be liable for any damages resulting from your use of this information. Hence, none of the Company or its affiliates (nor any of their respective officers, employees, advisers or agents) accepts any responsibility for nor makes any representation or warranty, expressly or implied, as to the truth, accuracy or completeness of the information contained in this letter.*

*This letter does not constitute a prospectus under the Financial Instruments Trading Act (SFS 1991:980) and has thus not been reviewed by the Swedish Financial Supervisory Authority ("SFSA").*

River Oak's book value per share increased by 74.3% in 2020. Our book value on December 31, 2020 was SEK 76.1 million, equivalent to SEK 267.22 per share.

| | Investment return (pretax) | Change in Book value per share | OMXS30 incl. div. | Difference |
|---|---|---|---|---|
| **2017 (from Feb 7)** | 13.2% | **8.6%** | 5.4% | 3.2% |
| **2018** | 0.0% | **(6.0)%** | (7.0)% | 1.0% |
| **2019** | 61.7% | **50.1%** | 30.7% | 19.4% |
| **2020** | 104.0% | **74.3%** | 7.4% | 66.9% |
| | | | | |
| **Total gain** | 273.4% | **167.2%** | 37.7% | 129.5% |
| **Compounded annual gain** | 40.2% | **28.7%** | 8.6% | 20.1% |

When evaluating investment results, it is my strong recommendation that you always look at the longest available period as shorter time periods with their inherent randomness won't tell you much of value. As always, I have included a full track record of the past eight years which includes the results of my Zen Capital Family Partnership from 2013-2016 at the end of this letter.

---

**Notes to table**

[1] Change in Book value per share is reported net of a reserved dividend on the A-shares equal to 20% of the gross book value increase according to the Company's Articles of Association, taxes and general operating costs.

[2] The OMXS30 column does not include having paid the standard annual tax on Swedish investment accounts.

[3] Estimated currency effects on Investment return: 2017 -10%; 2018 +5%, 2019 +3%, 2020 -6%

River Oak does not in any way strive to foresee or profit from currency movements. Our belief is that any impact from currency movements will be negligible over time.

**Fellow Shareholder,**

We were fortunate to do very well in a year that caused so much pain and loss for so many people around the world. Our results in 2020 happened because the companies we were invested in were well prepared to handle unprecedented circumstances – financially, culturally and in terms of their business model. They all adapted well and executed brilliantly. Our portfolio companies' average revenue growth was 36%, and their average operating earnings growth was 48%[1].

The second key to our results in 2020 was how we reacted in March. On March 16, 2020, our investments were marked down by almost 12% in a single day. If I had decided to sell all our investments during those scary days in mid-March and waited for things to "clear up", our full-year investment returns would have been negative 20% instead of the reported +104%. The ever-present moderate optimism that permeates River Oak once again proved to be a good attitude to have.

Howard Marks at Oaktree Capital once observed, *"A good builder is able to avoid construction flaws, while a poor builder incorporates construction flaws. When there are no earthquakes, you can't tell the difference."* This past year had one of the largest "earthquakes" imaginable. Construction flaws – such as an over-leveraged balance sheet, a slow-moving bureaucratic culture, or not having embraced the ongoing technology-driven tidal wave – came out in full bloom. They were seen in companies and in how different countries handled the situation; some were agile, alert and quickly able to adapt while others proved bureaucratic, incapable and sleep-walking their way to even the smallest of changes.

As usual, the world was not fair. If you were in the airlines, hospitality, or restaurant industries to name a few examples, it didn't matter if your construction was flawless – you still suffered heavily through no fault of your own.

As for River Oak, I am humble about the fact that if covid-19 had instead been an online server virus, it is fully possible that our companies would have been the dogs of the year. I also recognize that our type of companies – fast-growing, asset-light, highly-scalable market-leading technology companies with long runways for continued growth – have been in favor lately. They were already favored in 2019 (for good reason if you ask me) and then the pandemic hit and poured fuel on the fire.

The intrinsic business value of our companies has increased a substantial amount in the past few years – their stock prices have in some cases increased even more. The market has in most cases priced in a continuation of these companies' impressive results. In some cases, it will prove correct, while in some it will probably prove optimistic.

[1] The earnings growth of one of our portfolio companies was adjusted down from 5600% growth to 100% growth, as it went from essentially breakeven in 2019 to profitability in 2020, rendering its earnings growth number meaningless. The 48% operating earnings growth number is thus a fair bit understated.

A new investment we made in late December is excluded from the calculated averages.

## Predictions about the future

*"In 2020, we expect a once-in-a-fifty-years pandemic to hit the world. We expect to have one top-to-bottom drawdown in our portfolio of 30% and end the year with investment returns of more than 100%. We also expect our asset base to grow by 200%."*

If I would have communicated the following 2020 outlook to you at the end of 2019, most of you would probably have jumped in your car, drove straight to River Oak's office, and tried to get your money out (before giving me a ride to the nearest mental clinic).

Yet, this is exactly what happened.

Hopefully, you now have more sympathy for my poorly hidden skepticism of laying out detailed predictions about the future with a high degree of confidence.

I remember once listening to Charlie Scharf at the time he was CEO of Visa in an earnings call when an analyst asked him about their forward-looking guidance. After all, it seems reasonable to assume that the CEO of Visa has access to more high-quality data about consumer confidence trends etc. than most of us. He gave a great and honest answer:

*"Yeah, listen. This whole concept of guidance, it's a very strange thing because you're asking us what we think our volumes will be next quarter, the quarter after that and the quarter after that? And we know a little more than you know, not a whole lot more. So, asking people to give precision in terms of what's going to happen effectively to the dollar, consumer confidence, things like that. We really don't know."*

2020 was a masterclass in futile predictions. I don't believe I have ever heard more unqualified people make predictions with more conviction and based on less information than in the past year. Listening to one interview with an "expert" and reading a few random articles online does not qualify most people to make any conclusions about anything. As for pandemic experts, one of my friends that runs a very successful investment firm in Toronto and has a lot of resources to do good research told me at the start of the pandemic that they had talked to a lot of infectious disease experts about things such as $R_0$, ways of transmission and fatality rates – and practically all of them said different things.

When the world behaves roughly like it has in the past, it seems that most people can make decent predictions. When something unprecedented happens, which is also when successful predictions are the most valuable, it seems that very few people can.

Let's take a moment to salute all those who were diligent, who studied a lot of data, read dozens of studies, tried to form their own opinion through deep analysis, and at the end of it were still humble and confident enough to say the three magic words *"I don't know."*

Today, quite similarly to what happened after the 9/11 attacks, many people are extrapolating the recent past and are worried that the next pandemic is imminent and will arrive in one, five or ten years – when perhaps it is more likely, at least based on history, that the next one shows up in 50 years, or if we prepare ourselves better just like we did with airport security etc. after the 9/11 attacks, a new disease might never be able to wreck as much havoc in the world again. Who knows?

I only know what to do when I hear someone confidently predict future events with a high degree of certainty: turn on Spotify.

## Independence of thought

In March and April, it felt like I was one of the last people in Sweden saying that our pandemic response would produce very bad results in terms of lives lost. Laymen and doctors alike were willing to wager me that our response would prove to be the best one and that our Nordic neighbors would soon catch up to Sweden's high death rates, if not by summer than no later than March 31, 2021. Lately, these then very confident prognosticators (let's call them "CoPros") no longer want to evaluate what they said one year ago but instead casually say that our Nordic neighbors are most likely not relevant comparisons after all.

Why am I telling you this? Because many CoPros are smart and well-educated people. The reason they believed Sweden's response was the best in the world was because 1) A few leading Swedish authorities with supposedly relevant experience said so, and 2) These authorities had a 70%+ approval rating, and it's always nice to be on the side of the majority.

What the CoPros failed to take into account was that these same authorities had been completely wrong on pretty much every important pandemic-related matter they had predicted thus far, such as in late February and early March when they assured the media that *"We will be able to handle the few isolated cases that come to Sweden",* and *"We should not need to have a continued spread in Sweden unless we are very unlucky in different ways",* or a few weeks later when they predicted that the worst would be over as soon as all imported cases from the Italian Alps had died down. As these predictions quickly proved wrong, they made a full 360 and confidently predicted that Sweden would reach herd immunity by May.

If you were looking at the actual numbers, studied the alert and much humbler responses of our Nordic neighbours and read international news, it was easy to conclude that the confidence exuded by the CoPros was very ill-placed. Today, we all know how it turned out. Nevertheless, it can be very challenging to stand firm against a large majority backed up by leading authorities.

To get to my point: at River Oak, I will never make decisions based on how many people agree with me – or the titles of those who disagree with me. Our two new Board members, which are introduced in the 'Annual meeting & Corporate updates' section on page 15, work the same way. We will doggedly pursue important facts, apply intense analysis and reasoning, and we will listen to and discuss with people whose opinions and judgments have proven valuable and correct in the past – regardless of their titles or resumes.

One thing I have always loved about investing is that opinions don't matter, screaming the loudest doesn't matter, having fancy titles doesn't matter. Being right matters.

## Our investments

This section is quite extensive this time. If you want to go straight to our annual meeting information and corporate updates, feel free to skip directly to page 14.

I usually don't discuss our investments much in these public letters, but this year I think it is useful to discuss them a bit more extensively as it was quite an extraordinary year in which an investment firms' area of focus mattered greatly.

I will highlight our first filter that is always applied to all our potential investments, then comment on our actions in the first quarter of 2020, two sells and two new investments, and then there will be a deeper dive on one of the investments we made long before covid-19 existed which gives a good overview of the themes and types of companies I am looking for on our behalf.

### Does the company provide value?

Successful investment firms are sometimes criticized that the only thing they do is move money around. I view what River Oak does in a completely different light: Our job is to allocate capital towards companies that make the world better today and will help make the world better tomorrow.

Thus, I am looking for companies that promote and ride on strong trends that I believe are good for the world (companies that promote harmful addictions such as smoking and gambling, lottery providers, fossil fuel power plants, etc. are examples of companies that do not make the cut). At River Oak, we have a particularly soft spot for companies that enable entrepreneurship. In most nations, small and medium sized enterprises make up more than 95% of all companies, create more than 50% of all new jobs (often much more) and generate a disproportionately large share of overall economic growth[2].

Before I spend any time studying a new company for potential investment, I always start by asking,

1. Does this company provide value for its customers and their end users?
2. Would I want my children and my friends to use this company's products?
3. Would I want my children and my friends to work at this company?

When the answer is 'No' to any of the above, count River Oak out.

It is not lost on me that many big investment winners especially in Sweden, past and probably future, reside in the gambling industry. Not touching them will potentially hurt our returns over time, but it makes me and hopefully all of you feel much better about River Oak. The most common objection I hear to this is that the only thing it will accomplish is that others will be there to take those profits instead. Yes, that is often true, and I am happy to leave those potential profits to other investors.

[2] OECD enterprise statistics

**Q1-2020**

A single quarter is rarely very eventful at River Oak. The first quarter of 2020 was an exception.

Changing one's mind is difficult, particularly under stressful conditions. That is why one of River Oak's main investment objectives is to minimize the likelihood for future problems, which also minimizes the number of times I need to change my mind. In practice, this means that the bar for River Oak's investments is very high on the quality dimension.

At the height of battle in March, this provided us with the huge benefit of me not having to make almost any changes to our portfolio. The fewer decisions that need to be made under tough circumstances such as those prevailing in March of 2020, the better the outcome is likely to be.

I did make a few changes, however. As I mentioned in my half-year letter, I decided to sell two of our investments in the first quarter due to my concern about covid-19. These were Fiat Chrysler and Adevinta. To be fair, both were already two of our smaller holdings entering 2020 and, on the way to be sold to make room for other more attractive investments I had in mind. The pandemic however sped up my plans. (You could rightfully ask why I held on to our "least attractive" investments in the first place. The answer is that oftentimes I think our least attractive investments are very attractive too; you can think of our portfolio as the ten last remaining coconuts on a desert island.)

A few days later we made two new investments in Sinch and Netflix as I believed they would be able to handle the pandemic well no matter how it turned out, and importantly, be good investments after the pandemic had subsided too. It is important to note that I made both investments not because I saw a huge upside, but because I believed the downside was very well protected based on business quality and the price paid, at a time of great uncertainty. As many smart people have said, 'take care of your downside and the upside takes care of itself.'

I always seek to invest in companies where the price we pay, with a very high likelihood, promises a return which compares favorably to all our available alternatives, of which long-term interest rates serve as an absolute baseline rate[3]. I will however happily trade much of the prospective returns for a greater certainty. While I always strive for the return comparison to be as favorable as possible, it always takes a backseat to my degree of conviction.

These two changes worked out very well for us, but it is important to note that their total net contribution to our 2020 returns was ~15%, meaning that without them our full-year returns would still have been +89%. I would argue that this is quite a strong argument *against* trying to be smart and feeling a need to act during periods of market upheaval. It is much harder than most people think to come out from them with a net positive.

[3] A smart friend of mine correctly observed that I don't invest in 10-year or 30-year Treasuries, so then why do I take them into account? Well, he is right that currently I do not, but if they yielded 6% or 8%, I would.

FCA

FIAT CHRYSLER AUTOMOBILES

Fiat Chrysler Automobiles was one of our Day 1 investments, and on a personal level my family has been invested in FCA since early 2014. At that time, Ferrari was part of the FCA car conglomerate and the whole company was priced at less than €10 billion in the market.

Since 2004, FCA has been very well managed by its masterful CEO Sergio Marchionne. From 2014 when my family initially invested until Sergio's tragic passing in 2018, FCA's operating earnings increased almost 3-fold to ~€7 billion, not counting Ferrari which was spun off along the way and today sports a stand-alone valuation of €50 billion all by itself. FCA's reinvestment needs just to stay competitive however are massive and have increased too, so owner earnings excluding Ferrari didn't increase in lockstep with operating earnings over this period. (River Oak did not benefit from Sergio's excellence steering Ferrari as the spinoff was done in 2016 a year before River Oak was founded.)

After Sergio, the new CEO Mike Manley did a stellar job which ended in a merger with Peugeot that was announced in late 2019 and consummated in early 2021, to create the massive, combined unit Stellantis. Scale is great for car companies, Peugeot CEO Carlos Tavares who is now CEO of the combined unit seems to be of the same caliber as Sergio, and I believe Stellantis' future is bright.

So why did we sell? The complexity of FCA with its hundreds of thousands of employees, its employee unions, its enormous factory footprint, and its many different production lines all over the world, is just orders of magnitude greater than the software and online-based businesses that constitute the vast majority of our portfolio. The latter often have no more than a few hundred or a few thousand employees, a physical footprint that consists of a few offices and servers, and little need for capital investments except to fuel growth which in most cases is covered by internally generated cash flow.

To give you a somewhat simplistic but illustrative example, think about if you need to retool an automobile plant to be able to produce cars with electric engines instead of combustion engines. You likely need to halt production for a few weeks or months until you have replaced a lot of machinery, fine-tuned processes, re-educated factory workers and tested everything thoroughly. Whereas in a software company, when it needs to adopt a completely new framework or software, its developers simply download it, install it and start writing their code with a slightly different syntax.

To add insult to injury, the latter often has a stronger moat, scales much better, and has a far longer runway to grow. It is simply not a fair game.

Our investment in FCA contributed greatly to our returns in 2017 but was thereafter a drag on our performance in 2018 and 2019. Nonetheless, it provided many useful lessons along the way – the primary one being that over a long enough timeframe, a company's business model, its competitive position, the industry in which it operates, and its runway for growth are far more important factors for successful investment than a low price and a world-class management team.

Thank you, Sergio, Mike, Chairman John Elkann, all other leaders and all employees at FCA for the years we were allowed to be your business partners. Congratulations to you for pulling of not one but two of the greatest comebacks in automaker history, first with Fiat in 2004 and then with Chrysler after the 2008 financial crisis, and best of luck on your Stellantis journey. You are a great inspiration to many.

# Adevinta

Adevinta is a global online classifieds company that operates in 16 countries, attracting 1.3 billion average monthly visits. Their most dominant marketplaces are in France, Spain and Brazil. In some markets, their sites are the third most visited trailing only Google and Facebook. For example, more than 40% of France's population visit one of Adevinta's sites every month to find a new job, to buy or sell a home, a car, or other used goods.

Our investment in Adevinta originated as a spinoff from Schibsted in 2019 which in turn was made because I was very excited about Schibsted's French, Spanish and Nordic online classifieds assets. Schibsted also owns some media assets such as newspapers Aftonbladet, SvD and Verdens Gang which I wasn't equally excited about. In the spinoff, the Nordic media assets, and Nordic classifieds platforms such as Blocket in Sweden and Finn.no in Norway stayed in Schibsted, while all other classifieds assets were put into Adevinta to form a global pure online classifieds company. Hence, after the spinoff, given that most of the exciting assets were now in Adevinta, I exchanged our remaining Schibsted shares for a larger position in Adevinta.

As mentioned, the decision to sell our Adevinta holding in March-2020 was already in the works before covid. When it hit, the combination of my concern about how France, Spain and Brazil would be able to handle the pandemic, and the many other great investment opportunities that were available in March, sped up my plans to sell.

Adevinta managed the year well considering that both their main markets were impacted by severe covid lockdowns, and they ended the year with total revenue down 2% and earnings down 6% (compared to +15% and +32% respectively in 2019).

After we sold, Adevinta acquired eBay's classifieds division to become one of the largest tech companies in Europe.

Overall, our investment in Adevinta contributed a few % to our results over our quite short holding period. Adevinta is a great company, and I could definitely see us investing in Adevinta again.

Sinch is a global communications company founded and based in Sweden. It was previously called CLX Communications before a name change in early 2019. It has been profitable since its founding in 2008.

Sinch provides a platform for sending messages of all kinds all over the world, allowing companies to communicate efficiently with their customers regarding things such as 2-factor authentication, password resets, ticket and booking information, etc.

Sinch main focus is SMS which is a very effective means of communication. There are more than five billion unique active users which compares favorably even to platforms like Facebook, and the open rate of SMS is 35x email. Sinch makes a few SEK cents per message sent by its customers.

To understand why companies choose Sinch as their communications partner, let's look at one example. Sinch has deals with more than 300 mobile operators all over the world. Sometimes you have a situation where Sinch, or one of its licensed subcontractors, has a long-term exclusivity agreement with say Telenor for SMS messages in the Oslo region, which means that if you want to deliver SMS messages to anyone that has Telenor and lives in Oslo, you *have to* go through Sinch.

The U.S. part of their business is their largest by far in terms of revenue. It is also their fastest growing part at over 100% growth in 2020. Notably, eight of the ten largest U.S. tech companies are Sinch customers. The main reason why these companies choose Sinch is because of their proven ability to reliably handle huge message volumes being sent to a global audience with very few messages lost.

In addition, Sinch has proven very adept at acquisitions. Since we invested, Sinch has made three large transformational acquisitions: ACL in India, SAP's messaging division with global operations, and most recently Inteliquent which is the leading voice communications company in the US. Just like Sinch on the messaging side, Inteliquent serves essentially all large high-volume players in the U.S. on the voice side (for example Zoom and Microsoft).

I had considered making this investment for a month or so before covid hit. When it did, it accelerated our timeline as Sinch share price fell by ~40% in a matter of weeks. It fell even though almost 95% of its business is in messaging which would be virtually unaffected by the pandemic, and I could even see quite a few scenarios in which this part of the business would have a tailwind rather than a headwind due to the pandemic.

At the time I believed Sinch would be able to generate SEK 1.0 to 1.5 billion in operating earnings in a few years. We invested at an enterprise value of approximately SEK 22 billion.

The aforementioned acquisitions have of course increased Sinch earnings power quite substantially since then. Furthermore, they not only verified Sinch' ability to find good deals, but substantially surprised me to the upside. One explanation for their ability to find these good deals is their founding team. Sinch has one of the better corporate management setups I have seen – a very good and recruited CEO, an operationally efficient organization, and the founding team (initially six founders) which is scouting for new deals all around the world. I view it as a near certainty that we will see more good deals at Sinch in the coming years.

## NETFLIX

Sometime in March-2020, a friend of mine Assaf Nathan who is co-founder of a successful investment firm in Israel and often very insightful called me and said, "*What do you think about Netflix now? Churn will be minimal, and at the same time the pandemic will postpone their production schedule. As a result, their cash flow should improve drastically*."

Netflix annual content production budget is a staggering sum these days, and a mere few months of delay would mean billions of dollars in postponed investments (this insight might seem trivial today but remember this was in mid-March when most investment firms were thinking about survival rather than things like this).

I replied that it was a clever insight, that I thought he was completely right about it and that I viewed Netflix as one of the absolute safest investments in the world at the time. "*What about all the competition?",* he asked me. "*Netflix is your electricity bill. The others are optional add-ons,"* I replied.

I get these types of calls and messages from fellow investors and friends regularly throughout any year, and I didn't think more about it then. On my way to the office the next day however, I reflected that investments I view as "one of the absolute safest in the world", are usually not very exciting and are rarely on my shortlist for potential investment.

With Netflix it was different. It had been on my radar for many years due to the enormous value it offers customers and its remarkable ability to successfully adapt to new consumer trends and launch new business models, always managing to outmanoeuvre its competition. I believe it now has an essentially impenetrable competitive position.

Its service offers one of the largest consumer surpluses (a concept I discussed in more detail here) I can think of. In short, consumer surplus is the extra value you get *above* the price you pay for a product or service. Google's search engine and your washing machine are two of the best examples of a high consumer surplus. In the case of Google, the price you pay is zero. As for the value, think about it as *"How much would I have to pay you to live without Google?"*

I updated my back-of-the-envelope model of Netflix and ended up making the investment shortly thereafter. So much for checklists.

While covid-19 was a big part of 2020, or rather *was* 2020, let's take a look at one of our investments that was made before covid-19 existed. The company, which is called StoneCo, is a great thematic example of the type of companies I look for.

In the land that is perhaps best known for fostering soccer superstars Pelé, Ronaldo and Ronaldinho, there are also great companies being built.

StoneCo is a technology company based in Brazil that provides payment solutions and business management software for small and medium-sized businesses ("SMBs") to help them sell in-store, online and through mobile channels.

In early 2019, I had studied Brazil as a side-project for some time with increasing interest. My interest was piqued for a few reasons:

1. The size of the country – with a population of 210 million, Brazil is the 8th largest economy in the world.
2. Brazil was on its way out of a deep multi-year recession with the unemployment rate having recently peaked.
3. The people of Brazil had endured multiple government corruption scandals that were now largely behind them and a new president had just been elected.
4. Finally, and by far the most important factor for River Oak's purposes, I had seen some rather stunning statistics[4] for Brazil which showed a lot of potential for Brazilian tech companies. In terms of Brazil's adult population, only:

- 70% had a bank account

- 60% were internet users

- 27% had a credit card[5]

- 18% used the internet to pay bills to buy things

- 4% make payments using a mobile phone (vs ~30% in Western countries) even though 60% of the population are smartphone owners.

[4] World Bank. Data from 2015-2017 for population above 15 years of age.

[5] Banks are restrictive giving out credit cards to people that have a bad payment record which many Brazilians do. It is also notable that around 30% of all transactions in Brazil are still made in cash.

**Brazil's payments market**

Until 2010, Brazil's payments acquiring market was a duopoly. To accept Visa payments in Brazil, you needed to go through VisaNet (today named Cielo) as the acquirer as they had an exclusivity agreement with Visa in Brazil. Redecard (today named Rede), the other large acquirer in Brazil at the time, had a similar agreement with MasterCard.

Thus, merchants often had to have two point-of-sale (POS) hardware terminals in their stores, one for each network. Furthermore, the POS terminals were not sold but rented so merchants had to pay monthly rent in addition to the very high fees in the 5% to 15% range that they were charged on all transactions. Finally, merchants were paid their balance with a delay of up to 30 days after a sale had been made in their store or restaurant.

In 2010, the market was de-regulated. It took a few years before other payment solutions were embraced. As late as 2015, incumbents Cielo and Rede still handled around 90% of all credit card transactions in Brazil. This is when new companies such as Stone and PagSeguro started to get real traction. Today, thankfully, most acquirers in Brazil accept payments by both Visa and Mastercard.

Both incumbent acquirers are owned by larger banks. Cielo is owned by Banco de Brazil and Bradesco, while Rede was acquired by Banco Itaú in 2012 shortly after the de-regulation. The incumbents were focused on larger merchants, while mostly ignoring SMBs and micro-merchants (payment volume of less than $5,000 per month). In many cases, the smaller merchants did not have POS terminals, so this segment of the market was the lowest-hanging fruit at the time and both Stone and PagSeguro focused here initially. When they started to get traction, Stone in particular turned its focus to the larger mid-sized merchant which churn less and is more profitable.

**The opportunity**

When Stone and PagSeguro entered the market, two main pain points existed for Brazilian merchants:

1. Customer service was terrible with call waiting times of 2-3h and poor local service for the POS terminals as the incumbents outsourced much of it.
2. Fees were often high, and in addition they were not disclosed in a transparent way.

Stone, which is founded by two serial entrepreneurs, Andre Street and Eduardo Pontes, seized on these pain points.

One of Stone's core values is that customers are the sole reason why it exists. Stone measure their customer service success by metrics such as "*Customer service calls rated as 'excellent' by our clients*" and "*Customer service calls resolved on first call*". Both metrics have hovered around 90% with the latter showing a very steady improvement over the past few years reaching 94% at the end of 2020. To give you some flavor of just how obsessive they are about getting the customer experience right, Stone's CEO Thiago Phau recently made a point of mentioning that the average waiting time on customer service calls has been improved from 5-6 seconds previously to 3-4 seconds in January and February.

Can you imagine how the merchants that are used to wait 2-3 hours in line at one of the legacy banks feel after hanging up with a Stone representative when their call was answered within seconds and their issue was resolved on the first call? They probably feel like they just had a conversation with God disguised as a Stone customer service agent.

In Brazil, the personal relationship is big. People love to get a real person helping them with their issue. Stone knew the value of this and started setting up local help shops, called Stone Hubs, with teams of 5 to 15 employees that would give personal help to merchants in the local area. When a Rede or Cielo POS terminal broke down, a restaurant sometimes had to wait for days and weeks before a replacement came as the POS delivery and the related customer service was often outsourced to 3rd parties. With Stone, someone would come out immediately and a new terminal was in place a few hours later.

To address the transparency issue and to remove all suspicions Brazilian merchants had built up over years of experiencing bad service, Stone implemented a dashboard which always showed the current merchant rates front and centre so there was no way they could be changed without the merchant noticing. Customers loved this. One former Stone employee who sometimes helped his potential clients with their Cielo equivalent dashboard says it was "*almost impossible to find the merchant rate there*". Another former Stone employee said that the incumbents were in some cases quietly increasing rates until the merchant noticed and started complaining about it, at which point the rate was lowered again.

Add to this the fact that Stone's total take rate is below 2% and it's easy to understand why merchants are jumping ship hand over fist to sign up with Stone.

## Competition

Besides the large banks, other notable companies in Brazil's payments industry include PagSeguro, Mercado Pago, and privately held Nubank. These three companies however focus primarily on consumers and micro-merchants, whereas Stone's focus is primarily on larger and mid-sized merchants.

In recent years, Stone has started to offer services to micro-merchants too, while PagSeguro has started doing the same to larger merchants so these two entrepreneurial disruptors will likely compete more and more over time. For now, Stone's main competitors are the large banks while PagSeguro's main competitors are Mercado Pago and Nubank.

## Stone's competitive advantages

One of Stone's competitive advantages, perhaps counter-intuitively to some, is its relatively short life as a company and the fact that it started building its technology platform much later than the incumbents. The incumbents are now likely burdened by old legacy systems, and their owners also have large legacy banking operations (remember that both incumbent acquirers are owned by large banks) which they have tended to prioritize over developing their other offerings. Stone and PagSeguro on the other hand started with a clean slate less than ten years ago which enabled them to build a very modern, flexible, and scalable platform from Day 1. It is notable that this has become a quite common advantage for younger companies in today's rapidly developing technology-powered world.

Stone's main competitive advantage is probably its highly motivated workforce with its very customer-centric culture. Stone has many young, smart, and very driven employees. Many employees see their work at Stone as their life's mission.

Finally, Stone's founders' entrepreneurial background runs in the company's veins. Stone has a deep understanding of SMBs needs and they are fast and nimble compared to the incumbents. As one telling example, a former Rede employee explained that one of Banco Itaú's credit card solutions Credicard Pop uses an American company to process their transactions because if they did it on their own Rede platform it would be too slow. To fix this process at Rede and make it faster would be a big multi-year project according to this former Rede employee. As a result of Stone's speed of execution, while Stone started out mostly focused on POS terminals, it has today developed its offering into a fully-fledged software suite for companies of all sizes.

**Stone in our portfolio**

We made our initial investment in Stone in early 2019 at an enterprise value of around $6 billion. At the time, they had around 270k active merchants on their platform. There are approximately 9 million SMBs and 5 million micro-merchants in Brazil, so Stone's market share was in the low single digits while they were taking 20% to 30% of incremental volume in the industry. It was easy to see that the opportunity for Stone was huge.

Since then, active merchants on Stone's platform have tripled, revenue has doubled, and net income has tripled. Due to a combination of a rapidly increasing share price and an almost equally rapid decline in the value of the Brazilian real vs the US dollar over the past two years[6], I reduced our position in Stone in December at an enterprise value of around $24 billion. Stone has roughly 10% more shares outstanding today than it did in early 2019, so the total return on our sold shares was around +240% which works out to +95% annualized since our initial investment.

[6] The Brazilian real declined approximately 30% vs the US dollar over the past two years.

Stone is listed in the United States with US dollars (USD) being its trading currency. Its revenue and income however are in Brazilian real (BRL). All else equal, a lower BRL means that the company's earnings power in USD becomes lower, and thus its intrinsic value in USD becomes lower as well.

While we rarely sell, all our investments are continuously evaluated and compared to our available alternatives. I reduced our position in Stone not because I believed cash was a better option – but to invest in a Nordic company that came across my desk in December that I found more attractive at the time. It is worth mentioning here that the degree of difficulty for me investing in a Brazilian company is of course magnitudes greater than in a Nordic one, so if I have two similar opportunities, I will tend to prefer the Nordic option.

A small entrepreneurial founder-led company that is obsessive about its customers, has an enormous runway for growth, and whose mission it is to enable and empower entrepreneurship while disrupting large incumbent banks, is about as good as it gets for us in terms of investment candidates, and aligns like a tailor-made glove with River Oak's wider purpose of helping drive positive change in the world.

I will not go into any detailed assumptions about Stone's potential future numbers here. Their opportunity was huge in 2019 when we made our initial investment – today, with 770k active merchants on their platform, their market share is still in the single digits and their opportunity remains huge. From today's enterprise value of around $17 billion, I believe Stone, even if a significant multiple compression were to occur, will return at least 15% per year for us going forward (which roughly translates to a double in five years). As you know, 15% per year is the minimum hurdle rate for our investments as well as our long-term goal.

While Stone has a smaller weight in our portfolio today compared to 2019 due to a higher valuation, a *much* lower Brazilian real, and our other available investment alternatives, I am very excited that River Oak is a shareholder and I believe Stone's future is as bright as ever.

## Annual meeting & Corporate updates

Our annual meeting on Sunday, April 25th, will be particularly fun this year.

As a first unusual positive, the formal part will be done in advance by postal voting this year in accordance with temporary pandemic laws, so no 30 minutes of Yes' and No's this year. While the voting might not be very exciting to most of you, the formal part does contain some meaningful items this year which are described below.

In the non-formal part, which will be held over video link like last year, I will present River Oak's first quarter results, discuss long-term results, and take questions. If you have a question you want to ask me or any of our Board members (new or old), send it by email to our moderator Tilman Versch at tilman.versch@good-investing.net no later than April 23, 2021.

As a second unusual positive, we will then be joined by Juha Varelius, CEO of Qt Group, a Finnish-based software company that I call the Photoshop of smart-screen software, for a 30-minute panel discussion about Qt and its background. For a video teaser of Qt Group and its business applications, click here. **Don't miss the chance to hear directly from one of the CEOs of the companies River Oak is invested in!**

All shareholders and their families are welcome to attend the informal part of the meeting without voting or registering in advance. A link to join the meeting will be sent out to all shareholders the week before the meeting.

For the formal voting part, Lars Kylberg at PwC will be proposed to become the company's auditor. River Oak does not fulfill the legal requirements for an auditor to be mandatory, and while I have so far been hesitant to add any non-required costs, I saw many benefits for the company to retain an auditor (primarily in the long-term) and the Board unanimously supported the suggestion. I have already started working with Lars and have been impressed with his easy-going efficiency.

I am delighted to announce that two new Board members, Amir Dov and Arimatti Alhanko, have been proposed to join our Board. Our current Board members, Anna Åhr and Stefan Sjöö, will not stand for re-election this year.

We started very small, and I had no experience of how to run a company that had more than three shareholders. Thus, much of the Board's work in the first few years was focused on things such as corporate law, best practices etc. Today, we are quite a bit larger, the infrastructure we need is in place and our corporate filings are efficiently handled. Our future Board work will be much more focused on investing, evaluating deals and general strategic decisions.

Amir Dov is the founder and managing partner of Reading Global, an equity fund with a focus on high-conviction, long-term investment ideas. Since it was established in 2015, Reading Global's investments have outperformed the fund's benchmark by about 9% per year. Reading Global and its sister fund, Reading Capital, manage a combined SEK 900 million on behalf of family offices and high-net-worth individuals, mostly in Israel.

Arimatti Alhanko is a senior investment manager at Luxembourg Finance House where he advises a public equity portfolio of SEK 700 million and helps evaluate potential private investments. He previously worked at Banque Havilland where he launched two new equity portfolios in 2018/2019, both handily outperforming the benchmark indices. With his private investments, he has generated an annualized return of 36% over the past 5-year period. Arimatti holds double MSc degrees, one in Engineering and one in Finance. Arimatti who is born in Finland was also the person that initially alerted me to Qt Group which you will hear more about at the annual meeting.

Amir is focused globally, while Arimatti has a strong focus in the Nordics and a lot of experience in Europe. Both are very passionate about investing and business and have extensive experience of evaluating potential investments. As it happens, both bought their first stock at the age of 13. Given the quality and the number of investment opportunities they are regularly exposed to, I believe their expertise on our Board will materially increase River Oak's opportunity set. I am very happy to welcome them both to our Board.

River Oak is far stronger as a company today because of our departing Board members Anna Åhr and Stefan Sjöö. Anna has been a great sounding board for all kinds of corporate, communications and other questions I have had over the past four years. She has also been brilliant at getting to the essence of things quickly. Stefan has been a good sounding board not only over the past four years, but also in the year that preceded River Oak's founding. When lawyers and people in the financial industry were telling me to come back "in a few years" (think Jamie and Charlie at the JP Morgan meeting in The Big Short movie), Stefan was one of our Day 1 investors that took time out of his schedule and listened despite my then unfinished plans. Stefan also encouraged me to present River Oak to a small group of people in our first year, which resulted in a handful of new early investors that have been a great addition to our journey so far.

Both Anna and Stefan will remain as large shareholders. Please join me at the meeting to thank them because our 1st leg as a company couldn't have been much better.

At the extraordinary general meeting that was held on March 27th, more than 90% of shareholders casted their vote (Barack Obama would be proud) to amend the Articles of Association according to the proposal put forth by the Board of Directors. The amendment means that the company will from now on pay a dividend on the A-shares equivalent to 20% of the company's book value increase each year (a vast majority of this dividend will continuously be re-invested in the company). Given our recent good results, a few years' worth of salary costs has now accrued in our books meaning that no salary payouts will affect our book value in the coming three years. In addition, our capital base is now magnitudes larger than our average over the past four years, so the company's fixed costs are now expected to be between 0.1% to 0.5% of the capital base in the coming years which is magnitudes lower than previously.

These items will have a positive impact on our overall profitability as the company previously allocated 25% of the company's book value increase in a year towards personnel costs and related taxes, and we used to have fixed costs that were materially higher as a percentage of our total assets. The impact will be positive in all years – in unusually good years such as the past two years, the impact will be quite significant – thinking about it over the long-term factoring in the effects of compound interest, it will be even better.

**Looking back and ahead**

River Oak now has more than 50 shareholders from six different countries and three different continents (only Africa, Antarctica, Asia and South America to go).

Four years ago, on January 20, 2017, the new president Donald Trump was sworn in. To many people the world felt like in limbo, and many were worried about the new direction the United States was taking and what that would mean for the world and the capital markets. Less than three weeks later, on February 6, 2017, an unperturbed small investment company was incorporated in Uppsala and made its first investments the following day. Quite a few people were hesitant to invest even parts of their savings then, and many people were too worried about the future to invest anything at all at the time. However, a few brave souls did invest to become River Oak's Day 1 investors.

Today, as Trump's presidency ended in dramatic fashion with a historical second impeachment trial in as many years, looking back over the past four years there was no shortage of controversy or global crises; none the least the ongoing pandemic. Some would probably label the past 4-year period as the most dramatic, eventful, and uncertain since World War II.

Despite all this, over these same four years, River Oak's Day 1 investors have at the time of this writing more than tripled their money, which corresponds to an annualized rate of more than 30%. This has been achieved by investing in well-managed companies that provide great value for its customers, have solid business models, strong balance sheets and a bright future. While our return rate is very unlikely to be maintained, it shows that River Oak's strategy of focusing on the micro and keeping things simple works well almost no matter what is going on in the world at large.

We will continue in the same fashion: focusing on great companies and the great people that build them rather than macro events, stock prices and market sentiments.

Our flying start notwithstanding, any continued success we may enjoy will require a humble mindset and an open mind that is prepared to change and adapt to discover new areas of focus for our investments when the world changes. For change it will. Every successful company in the history of the world has constantly had to adapt to new realities. Those companies that didn't are those that most of us don't remember anymore.

The best results in most endeavours are achieved by always looking ahead and focusing on the future. Which player is more likely to become better over time – the one that stands in the middle of the field, hands on hips, admiring the scoreboard, or the one that leaves the field not even looking at the scoreboard, fully occupied thinking about the things that can be improved to the next game? For you as a shareholder and me as CEO, this means not being too celebratory over recent good results or being too low over recent poor results, but rather staying even keel, living always "in the middle".

For now, we are on a good path. To use Alice Schroeder parlance: the snowball is rolling.

April 16, 2021

Daniel Glaser
Chief Executive Officer

**Founding principles**

Our basic idea is simple:

1. **Make a bet on human progress.**

   Human progress is the reason why stock markets have historically produced average annual returns of 6% to 10% over the past 200 years.

2. **Invest in companies that are better than average or available at lower prices.**

   The objective here is to add some additional returns on top of the 6%+ returns that the general market has provided and is likely to keep providing investors over time.

**Goals**

1. **Don't lose money.**

   We always think about the downside first.

2. **Earn an average annual investment return of 15% over time.**

   This will result in an average annual increase in book value per share of ~11.5% after taxes and general operating costs.

## Historical returns

Feb 7, 2017 – Dec 31, 2020: River Oak Capital AB
Jan 1, 2013 – Feb 6, 2017: Zen Capital Family Partnership

| | Investment return (pretax) | Net result | OMXS30 incl. div. | Difference |
|---|---|---|---|---|
| **2013** | 41.0% | **30.8%** | 25.5% | 5.3% |
| **2014** | 45.0% | **33.8%** | 14.0% | 19.8% |
| **2015** | 35.1% | **26.3%** | 2.2% | 24.1% |
| **2016** | 20.5% | **15.4%** | 9.4% | 6.0% |
| **2017** | 19.6% | **14.0%** | 7.7% | 6.3% |
| **2018** | 0.0% | **(6.0)%** | (7.0)% | 1.0% |
| **2019** | 61.7% | **50.1%** | 30.7% | 19.4% |
| **2020** | 104.0% | **74.3%** | 7.4% | 66.9% |
| | | | | |
| **Total gain** | 1213.0% | **615.0%** | 124.8% | 490.2% |
| **Compounded annual gain** | 38.0% | **27.9%** | 10.7% | 17.2% |

**Notes to table:**

[1] Change in Book value per share is reported net of a 20% dividend on the A-shares according to the Company's Articles of Association, taxes and general operating costs.

[2] The OMXS30 column does not include having paid the standard annual tax on Swedish investment accounts.

[3] Estimated currency effects on Investment return: 2014 +7%, 2016 +2%, 2017 -10%; 2018 +5%, 2019 +3%, 2020 -6%, years not mentioned <1%

River Oak does not in any way strive to foresee or profit from currency movements. Our belief is that any impact from currency movements will be negligible over time.