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26 July 2022

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BY ELECTRONIC LODGEMENT

VG1 Investor Letter – Year to 30 June 2022

VGI Partners Global Investments Limited (ASX:VG1) is pleased to make available the enclosed Investor Letter.

The letter provides details on the performance of VG1 for the twelve months ended 30 June 2022 and commentary on current positioning.

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VGI PARTNERS
Global Investments

Investor Letter

26 July 2022

Dear Fellow Investors,

For the twelve months ended 30 June 2022 (FY22), **VGI Partners Global Investments Limited** (ASX:VG1) generated a net return of **-27.3%**.[1] This has been a humbling year for performance and represents the largest decline the portfolio has incurred since its inception. Two-thirds of this decline can be attributed to three long positions in the portfolio: Pinterest, Amazon and Qualtrics. We discuss these positions in more detail throughout the letter. Pleasingly, the portfolio's short positions were strong positive contributors, generating substantial returns while also helping to insulate the long investments from the broader market sell-off.

Over the last six to twelve months we have seen a dramatic recalibration in the price of risk. The primary question now is whether the current inflationary environment will prove persistent or transitory as demand destruction kicks in. This will have significant implications for discount rates and, therefore, valuation levels of all assets. Central banks are laser-focused on forcing inflation lower – this is well flagged and is now market consensus. The key question in our mind is how much further monetary tightening can be tolerated before highly indebted Western governments and their consumers begin to reel from the pain. We remain mentally prepared for a scenario where rapid rate rises are just as quickly unwound and Quantitative Easing is re-instated to support recessed economies and fragile consumers.

Already we have seen the air come out of many bubbles like crypto and SPACs and all before the Fed even withdraws excess liquidity from the system via Quantitative Tightening. There still remain some pockets that have been slow to adjust to the new reality - one being the venture capital space where we have only seen a handful of markdowns relative to what one would expect. We have already seen meaningful valuation multiple reductions across many sectors, however the risk now is we start to see corporate earnings come under pressure as demand destruction begins to take effect. Some of the aggregate labor data, at least in the US, has already started to decelerate and anecdotally we are seeing a broad range of companies, especially technology firms, become more cost vigilant to preserve profitability.

Despite this backdrop, the indiscriminate equity market sell-off has created some compelling opportunities. Over the last six months we have initiated several new positions – many of which are digitally-enabled businesses that possess increasing competitive advantages, impressive growth runways and are trading at attractive valuations.

We strongly believe that structural growth is going to become increasingly scarce and hence remain focused on owning businesses where we have high confidence in their competitive moat, industry structure, addressable opportunity and pathway for multi-year growth in free cashflow.

[1] Past performance is not a reliable indicator of future performance and should not be relied upon as an indication of the future performance of any fund or strategy.

The current environment has drastically cut the flow of equity funding to listed and unlisted corporates, especially to digital businesses which show little evidence of compelling unit economics despite reaching scale (for example food delivery, Buy-Now-Pay-Later and property iBuying) and those competing with established incumbents (such as digital payments). It follows that the competitive environment is dramatically improving for many established digitally-enabled businesses and it is the well-funded incumbents with attractive unit economics and high switching costs that should thrive. Within the software space we are likely to see a divergence between ‘must-haves’ and ‘nice-to-haves’. This is one of the areas where we have been focusing our efforts and believe a number of portfolio holdings fit this criterion.

In summary, we continue to focus our efforts on owning attractively priced, high-quality businesses that are competitively well positioned and operating in industries exposed to long-term growth. We also continue to concentrate capital in our highest conviction ideas – as such our Top 10 holdings represent approximately 72% of total portfolio long capital. Our largest holdings are largely unchanged although we have made some adjustments over the past six months, including the divestment of Yakult, some new additions (such as Deutsche Boerse) as well as beginning to re-build our holding in Palantir.

Merger with Regal Funds Management

Before we discuss the portfolio in detail, we would like to make a few comments about the recent merger of VGI Partners with Regal Funds Management.

At the end of March, we were pleased to inform investors and shareholders that VGI Partners and Regal Funds Management had entered into a Merger Implementation Deed, combining two well-established investment management businesses and creating a market-leading manager of alternative investment strategies. Following receipt of the required regulatory and shareholder approvals in May, the merger completed on 3 June 2022, with the new combined entity renamed ‘Regal Partners’.

We are pleased to report the merger has progressed well. The VGI Partners investment team continues to manage the VG1 portfolio, while the opportunities for VGI to leverage Regal Funds Management’s existing corporate platform and operating infrastructure are well underway. The key expected benefits of the combination have quickly begun to materialise, most notably in a reduction in time spent by the VGI Partners investment team on non-investment related activities, alongside continued opportunities to access Regal’s specialist investment expertise and operating capabilities.

Both VGI Partners and Regal share very similar philosophies around alignment with our investors, with key investment staff retaining meaningful shareholdings in the merged entity and substantial personal investments in the underlying funds and listed investment vehicles, including VG1.

The manager has also been supportive of recent initiatives taken by the VG1 Board and the VG1 Board’s strong focus on capital management. This includes having a defined dividend policy and VG1’s policy to target a fully franked dividend yield of 4% p.a. is a good example of this. VG1 has paid two fully franked dividends during FY22 (5.5c in September 2021 and 4.5c in April 2022).

In addition, a second element of capital management includes the provision of an active on-market share buy-back program whenever shares are trading at a discount to Net Tangible Assets. This not only provides greater on-market liquidity but can also be highly accretive for shareholders. Many VG1 shareholders would be aware that VG1 launched a buy-back program in August 2020. Post the merger completing in early June 2022, the pace of the buy-back has materially increased. Over 36m shares, or approximately 9% of VG1’s shares, have been bought back since the program began two years ago.

We thank investors and shareholders for their kind messages of support through the merger process and look forward to providing more updates through future briefings and letters.

Portfolio Update

Below we provide an update on our key holdings, the reasons we own them and why we are excited about each investment.

Current Portfolio

The table below shows our Top 10 holdings as at 30 June 2022. Consistent with our concentrated approach, the Top 10 holdings account for 72% of total capital.

Top 10 Long Investments as at 30 June 2022	% of Portfolio
Amazon.com Inc.	13%
CME Group Inc.	11%
Mastercard Inc.	9%
Cie Financière Richemont SA	9%
Olympus Corporation	7%
SAP SE	6%
Française des Jeux (FDJ)	5%
Pinterest Inc.	4%
Twitter Inc.	4%
Deutsche Boerse AG	3%

Source: VGI Partners.

Amazon (~13% weighting)

Amazon remains our largest holding – we are more excited about our investment in Amazon today than we have been in a long time.

Amazon continues to grow the depth and width of the moats around its key business operations being 1) e-commerce - Amazon remains the undisputed leader in global e-commerce, 2) cloud computing - Amazon Web Services (AWS) is the number one provider of cloud computing services globally and 3) advertising - Amazon Advertising is now the 3rd largest digital advertising platform in the world.

Amazon's share price has declined in line with the broader market sell-off along with concerns over the growth outlook for the e-commerce business, and the impact on profitability associated with excess fulfillment and transportation capacity alongside inflationary pressures. We view the e-commerce concerns as short-term headwinds which the business will navigate over the next six to twelve months. Most importantly, we believe the company's vertically integrated position in e-commerce is now materially stronger and scalable given the growth in its fulfillment and logistics footprint (Amazon Logistics already exceeds the capabilities of FedEx) and its Amazon Prime membership base (over 200m subscribers which generate $35bn in high margin subscription revenue) which acts as a powerful flywheel for the e-commerce and advertising business. Eventually we think the Prime membership base will be leveraged by new business operations that offer strong growth potential such as the Satellite Broadband business (Kuiper Systems) and Amazon Health.

In our view, Amazon's current share price is easily underpinned by AWS alone. We have this view for two main reasons: 1) we are still in the early stages of cloud adoption and 2) AWS continues to gain share in the most important cloud service, Database Management Systems (DBMS), which represents circa 40% of AWS revenues. With respect to cloud adoption, readers may be surprised to learn that Delta Airlines, one of the major US airlines, only this month selected AWS as its preferred cloud provider after a nearly 18-month process of modernising the company's applications to migrate them to the public cloud. AWS CEO Adam Selipsky said last month that only 10% of Information Technology has shifted to the cloud today and AWS could become the largest business at Amazon. DBMS revenues continue to shift to the cloud from on-premise, and AWS market share has grown from 9% in 2017 to 24% in 2021 (according to Gartner), rapidly displacing the incumbent Oracle, a trend which we expect to continue. AWS has numerous other ecosystem services beyond DBMS, and collectively, we expect AWS revenue growth to exceed current market expectations over the next several years.

We think the new CEO Andy Jassy is a fanatic and his primary financial objective, as stated in each result release, remains the same as when Jeff Bezos was CEO – "*Optimise Free Cash flow Per Share*!" We believe Amazon's free cash flow will be optimised primarily by increasing operating profit dollars and effective management of working capital and capital expenditures. We expect operating profit dollars to increase as price and efficiency initiatives start to offset inflation, labor productivity improves, and excess logistics capacity is reduced through offering Amazon Freight and Buy with Prime services – as a result Amazon is beginning to monetise the excess capacity in its fulfillment and transportation network, thereby turning an operating expense into a new revenue stream, similar to what it did with AWS.

We also believe that capital expenditures for Amazon's fulfillment and transportation network have peaked and will decrease substantially over the coming years. Whilst we anticipate elevated capital expenditures for AWS medium-term to support robust growth, we see decreasing capital intensity for AWS over the long term, as Amazon continues to make more efficient use of its hardware and the sales mix within AWS shifts towards software and services.

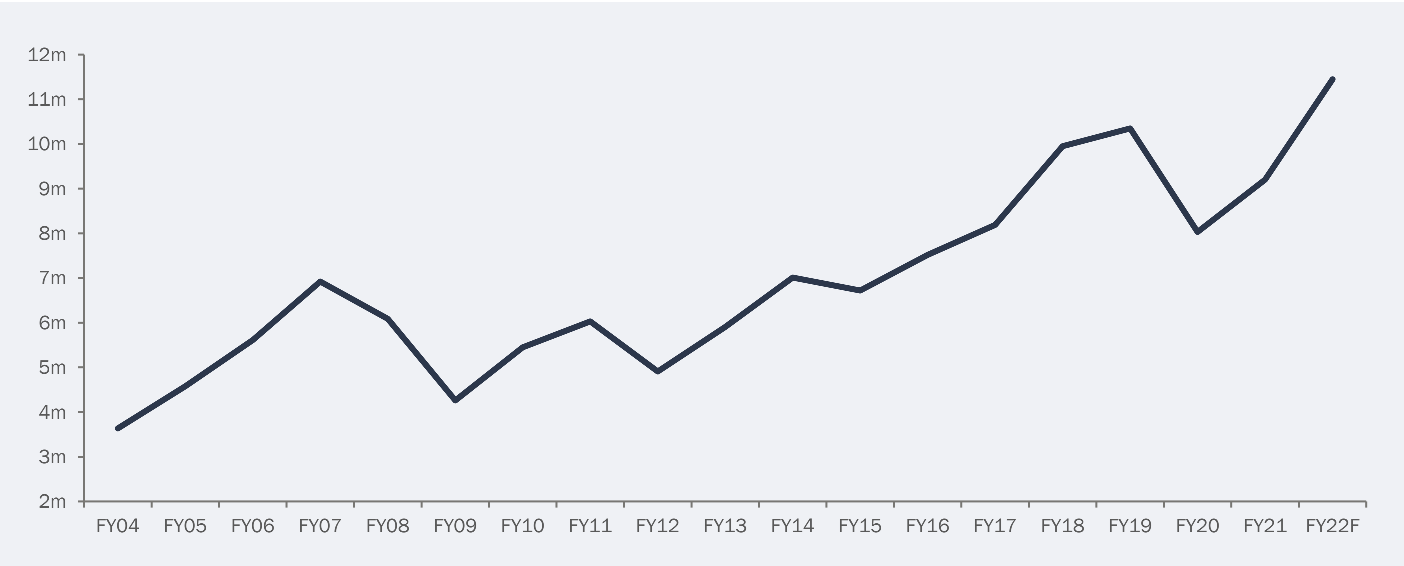
CME (~11% weighting)

CME is a business we have owned in our global strategy since 2008 and has grown into the portfolio's second largest position on the back of additional recent purchases and relative share price performance.

The CME business is one we have written about on numerous occasions and, as many of you would know, operates the most important derivatives exchange platform in the world, consisting of the Chicago Mercantile Exchange (CME), the Chicago Board of Trade (CBOT) and the New York Mercantile Exchange (NYMEX). On top of this, CME also owns other key assets related to FX Trading & Infrastructure and a strategic shareholding in Standard & Poor's (S&P) Index business.

A key profit driver for CME is its interest rate franchise which includes derivatives covering the entire US yield curve. The below chart highlights the growth (or lack there-of) in daily interest rate volumes from pre-Global Financial Crisis (GFC), to today.

CME Interest Rate Derivatives Average Daily Volume



Source: VGI Partners analysis.

The key point to note here is that after the drop-off post the GFC, the CME's interest volumes took nearly 8 years before they exceeded pre-GFC levels and since 2015 have grown modestly to current levels of approx. 11m contracts a day despite facing headwinds over this period from Quantitative Easing (QE). Given the recent policy shifts by the US Federal Reserve, we believe the outlook is highly favorable for CME's interest rate derivatives business, other derivatives complexes and net interest margin.

We should note that the CME operates primarily via a digital platform and therefore every incremental futures contract generates an extremely high drop-through rate from revenue to cash earnings. As such, given the current macro backdrop we see substantial upside risk to consensus earnings and free cashflow estimates.

Mastercard (~9% weighting)

Despite enjoying a powerful tailwind from the ongoing structural shift from cash to cashless, Mastercard continues to fortify the moat around its business through ongoing investments and acquisitions in the financial technology space with a focus on business-to-business payments and encryption.

Concerns that Mastercard and Visa would see their business undermined by the Buy-Now-Pay-Later (BNPL) operators has vanished, similar to the concerns a number of years ago stemming from the threat of Apple Pay (which operates on Mastercard technology). As it turns out, Mastercard (and Visa) networks remain remarkably well placed given their unique position, seamlessly connecting customers with merchants and credit card issuing banks. The origins of Visa and Mastercard as bank-owned utilities has allowed the establishment and proliferation of a network which is very difficult to replicate – ultimately it is this moat coupled with billions of dollars of ongoing investment in its network and technology that underpins its moat's durability.

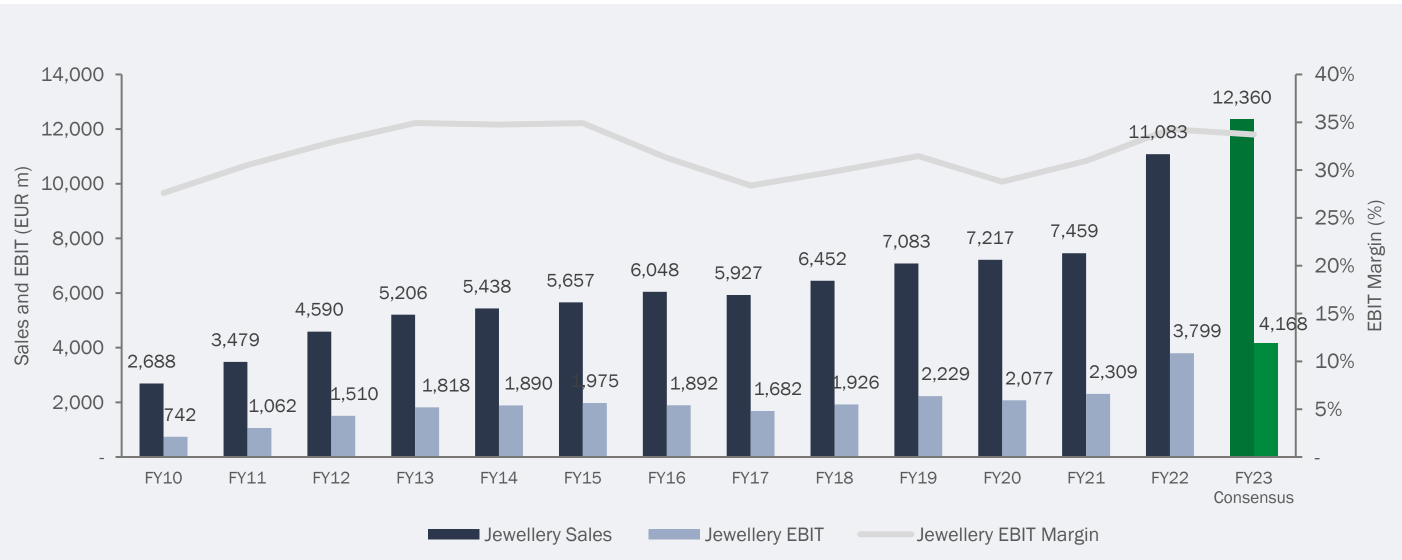
We nonetheless keep a watchful eye on growing risks and deem the acceleration of digitisation (such as account-to-account payments) coupled with the emergence of de-globalisation (national or regional real-time payment networks) as looming yet manageable threats to the Mastercard moat.

At current levels, we believe Mastercard is trading on the most attractive earnings metrics we have seen for many years given both the quality of the business and the underlying earnings growth profile.

Richemont (~9% weighting)

Richemont, a position we initiated in 2019, is our fourth largest holding and remains a key holding of our portfolio. Richemont's super luxury jewellery brands, Cartier and Van Cleef & Arpels, are the crown jewels of the group's portfolio of brands, posting consistent revenue growth and accounting for the vast majority of Richemont's total profitability.

Richemont Jewellery Segment Sales, EBIT and EBIT Margin



Source: Bloomberg, VGI Partners analysis.

The underlying driver of the jewellery segment's earning power has been the rising wealth amongst the top 1% of consumers, combined with a structural shift towards branded jewellery, the latter following a clear trend seen in the leather goods industry more than a decade ago. We believe that when these structural trends are combined with Cartier and Van Cleef's ever increasing brand equity and heritage, the tailwinds for multiple years of continued outperformance are significant. Alongside this segment, Richemont is supported by a transformed watches division (including brands such as Vacheron Constantin, Jaeger-LeCoultre, IWC and Panerai) and hidden upside in its online operations (Net-A-Porter, Mr. Porter & YOOX).

At Richemont's current valuation, our view is that the market is not only undervaluing the core jewellery business, but also ascribing next to no value to the other divisions. We think the valuation upside will become more obvious over time as the jewellery and watch business segments continue to perform and management executes on initiatives already in place to extract value from its online operations.

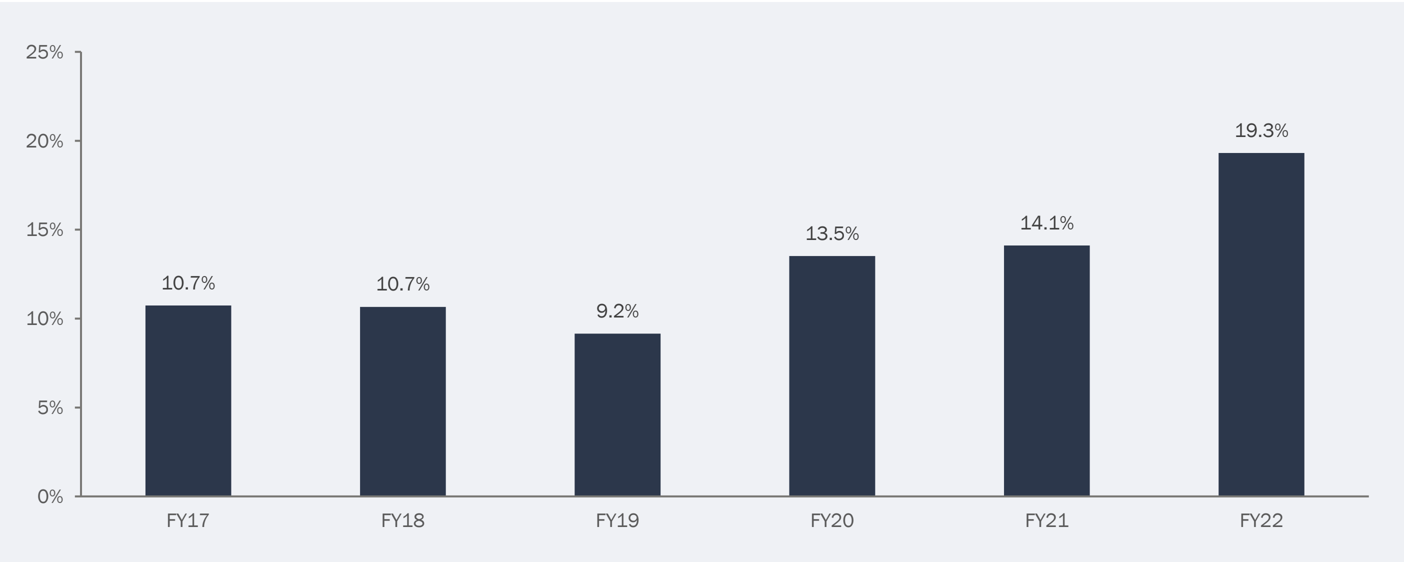
Olympus (~7% weighting)

Olympus was the largest long contributor during FY22. The strong share price performance has been driven by a combination of ongoing operational and structural improvements at the business, a weak Yen – which is positive for Japanese exporters such as Olympus – and ongoing strong earnings results.

Olympus is a medical technology company with circa 70% market share globally in gastrointestinal endoscopes. This dominant position has been captured through many years of investment and the development of a well-entrenched distribution network, both of which provide a strong moat around its business.

Olympus management has executed very well in recent years. They have continued to raise margins in the core business while simultaneously growing revenues in a difficult period. At the same time, management has divested non-core operations and become more aggressive around cost management, all the while still reinvesting in the business. We believe earnings are set to benefit from the launch of a higher-priced next generation gastrointestinal platform in the US this year, followed by other markets in years to come. Further growth is being driven by expansion into a broader range of related consumables, as well as new fields that leverage the existing technological expertise such as compact endoscopes for urology.

Olympus Operating Profit Margins



Source: VGI Partners analysis.

As at 30 June, Olympus was a 7% position but, as at writing, we have reduced our Olympus holding to circa 5%. The company still trades at a discount to our fair value estimates and on attractive prima facie metrics. While we still view upside to the valuation, we have taken the view that there are more compelling opportunities to deploy capital into. Within the medical technology sector, in particular, there are a number of exceptional businesses with strong, durable moats that have started trading at attractive valuations after the recent market sell-off and that we have started to study more closely.

SAP (~6% weighting)

SAP is a position we initiated in 2020 (we previously owned SAP in our global strategy between 2009 and 2012 and again during 2014) and since then we have opportunistically grown its weight. Our investment thesis is underpinned by the company's formidable Enterprise Resource Planning (ERP) platform which is utilised by many of the world's largest corporations. This platform was historically an on-premise solution and SAP have been slow to transition to a cloud or virtual platform. The pandemic was a catalyst for change and forced a reset at the company which has included a change in CEO and a pending change of CFO.

The transition from on-premise to cloud is complex for SAP and its customers, however the transition has accelerated and is gaining traction. S/4HANA Cloud is SAP's flagship ERP software designed for the cloud. S/4HANA Cloud has more than 6,000 customers including companies such as Microsoft, Allianz, Siemens and the NBA, and there are over 30,000 on-premise ERP customers yet to be transitioned to the cloud. Today S/4HANA Cloud is an approximately €1.5bn revenue business growing at over 70% per annum.

Critically, the transition of SAP's on-premise customer base to the cloud provides SAP an immense opportunity to cross-sell and up-sell. Some examples include adding modules such as SuccessFactors (customer relationship management (CRM) platform), Ariba (procurement spend management platform) and Concur (expense management platform). We see scope for SAP to increase its share of wallet with existing customers as they migrate to the cloud, creating a pull-through effect to the rest of SAP's cloud portfolio, thereby driving an acceleration in overall cloud revenues. This transition will be a strong source of growth for many years to come notwithstanding macro conditions.

While this transition takes place, SAP earnings will see a lull and this earnings plateau, coupled with uncertainty around management's ability to execute, has created what we believe to be an attractive opportunity to buy one of the more high-quality software earnings streams at a meaningful discount to fair value. We note that the largest shareholder, Co-founder and Chairman Hasso Plattner, has purchased over €150 million in stock in the last 12 months at an average price of €111.

We believe 2022 will be trough earnings for SAP and that earnings will accelerate as they execute on the cloud transition. In our view, a more meaningful reflection of the company's earnings power requires looking out to at least 2023 if not 2024 and beyond.

Française des Jeux (FDJ) (~5% weighting)

We have been FDJ shareholders since its IPO in late 2019. We view FDJ as a very high-quality asset with a growing and resilient earnings profile in the core French lottery monopoly business, combined with optionality from its adjacent activities (such as sports betting and supplying technology to other lottery operators). We slightly reduced our FDJ weight in 2021 as the share price strengthened but have subsequently increased our weighting given recent price weakness.

The share price has experienced pressure over the last twelve months due to 1) a regulatory overhang and 2) the increase in Euro interest rates. On the first point, we think the market is overly worried about the investigation by the European Commission into the granting of FDJ's lottery license by the French Government prior to the IPO. We take comfort in FDJ having a strong balance sheet that can comfortably fund a potential fine from cash-on-hand.

On the second point (higher European interest rates), we think the market is ascribing too high a discount rate to a business with infrastructure-like qualities, whose free cash flow profile is predictable and extremely resilient, even in an environment with weaker consumer spending (for context, waging turnover at FDJ declined just 3% during the GFC and still grew at a healthy pace throughout the euro-debt crisis of the early 2010s).

Most importantly, we think the market continues to under-appreciate the shift to online wagering, which is a very meaningful margin tailwind for FDJ. Penetration for online lottery in other developed markets like the UK and Australia is above 30%, whereas FDJ's online penetration today stands at 11%. We think FDJ can achieve similar levels over time which, if successful, would make the business substantially more valuable than it is today.

At writing, on our estimates, FDJ is trading at a significant discount to its long-term cashflow Net Present Value as well as trading on highly attractive prima facie valuation multiples.

Pinterest (~4% weighting)

Pinterest is an investment we have discussed in detail in recent letters. We initiated the position in 2020, and, after the share price increased nearly 4 times, it has since returned to the level where we initially purchased the position. As a result, in the twelve months to 30 June 2022, Pinterest was the largest detractor in the portfolio.

While always easier in hindsight, our mistake with Pinterest was with sizing. We allowed the position to grow into a 9% weight at its peak from a small initial weight and did not reduce the size of the investment as some of the underlying trends in the business started to deteriorate.

We gradually added to our position as the share price pulled back throughout the year as we remain confident about our Pinterest investment for a number of reasons. Firstly, we think Pinterest remains a unique visual search inspiration tool that is often misclassified as a social media platform. We think the value of its users, who show purchase intent, is incredibly valuable to advertisers. Secondly, we think the concerns around user declines are overstated. Pinterest's core users, those that navigate the mobile app rather than the web, are still growing by mid-single digits globally. These users are the most engaged, representing the vast majority of Pinterest's impressions and revenue (which in turn explains why revenue growth has remained well above user growth). Therefore we think focusing on reported headline users misses the full picture, and we have had multiple discussions with management to think about new ways to present the disclosure to investors.

Thirdly, we think that broader concerns around the pressure to digital advertising spend in a weaker economic environment are temporary (and to some extent already priced in). We also believe that because Pinterest still only captures a very small proportion of advertising budgets, we think the budget allocation to Pinterest is less likely to be cut, particularly when the Return on Ad Spend (ROAS) delivered by the Pinterest platform is superior than most other platforms.

Lastly, we remain of the view that there is still plenty of low-hanging fruit that the company is yet to take advantage of. For instance, Pinterest is yet to develop meaningful relationships with advertising agencies, despite these agencies being a very important decision-maker in ad budget allocations. The standard practice is to have representatives from digital ad platforms sit at an ad agency (or at least visit regularly) to help marketers understand the efficacy of a platform. This is something Facebook and Snap have done effectively, but which Pinterest is yet to introduce in any meaningful way.

On the international front, we see substantial runway for improvement. Pinterest has been slow to turn on advertising outside of the USA because it has been focused on growing engagement on the platform and also building an international salesforce. For example, Pinterest has only in recent months activated advertising in geographies such as Japan and South America.

With the recent appointment of a new CEO, Bill Ready, we think Pinterest is addressing some of these recent shortcomings. Mr Ready comes with an impressive background, previously having held senior positions at Google (leading their commerce strategy) and PayPal (COO of PayPal - he joined PayPal when it acquired Braintree/Venmo, where Mr Ready was the CEO). We think Mr Ready will bring a much-needed sense of urgency to Pinterest. Further we think it is particularly encouraging that Mr Ready has a commerce and payments background - clearly signaling the direction that Pinterest will focus on going forward.

It is also worth recalling that Pinterest has attracted interest from at least two suitors in the last 18 months, Microsoft and PayPal, which we think highlights the strategic value of a platform that captures over 400 million users that display high purchase intent. On top of this, at time of writing it was reported that Elliott Management, the well-regarded activist investor, has become Pinterest's largest shareholder by taking a 9% stake in the company. We think this will again help to bring urgency and a stronger focus on execution. We are not surprised by the Elliott move – with an enterprise value of just $10bn and trading on what we believe are deeply depressed multiples, despite the free cash flow generation we expect over the coming years, we think Pinterest is trading significantly below its fair value.

Twitter (~4% weighting)

Twitter is a holding we initiated in 2021 and accelerated building a position throughout this year. We had originally held a small investment in Twitter back in 2017.

We are attracted to Twitter due to its unique position as the digital public town square, where conversations gravitate to on broad topics, from news and politics to sports, gaming, education and more. We saw an opportunity for the platform to experience a meaningful improvement in monetisation after many years of under-performance, driven by 1) management changes, 2) activists pushing for better execution (Elliott and Silver Lake), 3) more innovation (both in terms of product and ad formats), 4) improvements to clean up the platform from unwanted content and 5) potential for significant margin expansion by optimising a highly inefficient cost base.

We also believed the asset had significant strategic value – this has turned out to be the case as Elon Musk earlier this year proceeded to first take a large stake in the company and seek a board seat, and then to make a full takeover bid for the company. The events that have played out since Musk's approach have been widely reported in the media, so we will not revisit them here.

As Elon Musk has now terminated the deal to acquire Twitter, the company is immersed in a legal battle to either force Musk to close the deal or negotiate a settlement. We think the company has a very strong case and think the most likely outcome is a settlement, either in the form of a renegotiated price (where Musk still goes ahead with the purchase at a slightly lower price), or Musk is forced to pay damages to Twitter (well in excess of the $1bn break-fee). We are mindful there is a small possibility that Musk succeeds in walking away from the deal, in which case we would be disappointed in the near-term; but ultimately our thesis was never predicated on a takeover and we think Twitter has the potential to be significantly more valuable over time.

Deutsche Boerse (~3% weighting)

Over the first half of the year we initiated a position in Deutsche Boerse (DB1), a company we know well and have previously owned in the portfolio.

DB1 is a German based financial exchange operator, facilitating trading and clearing for four broad asset classes being derivatives, cash equities, commodities, and foreign exchange. Alongside this, the business also offers data and analytic solutions, and pre- and post-trading services. The business is segmented into four key divisions: Data & Analytics, Trading & Clearing, Fund Services and Security Services. The Trading & Clearing business is the key revenue earner for DB1 and encompasses Eurex (Europe's largest derivatives exchange), Xetra (European cash equities and ETFs), EEX (Global commodity exchange of choice) and 360T (Global leader for listed and OTC foreign currency trading).

Similar to CME, the current macro backdrop acts as a powerful tailwind for DB1, in particular its Eurex derivatives business. After more than a decade of abnormally low interest rates, the ECB appears to be following the US Federal Reserve's lead – this acts as a favorable tailwind for the interest rate complex within Eurex and the group's net interest margin earnings stream. As per CME, DB1 operates a digital platform which enables a high drop through to cash earnings from each incremental dollar of trading revenue.

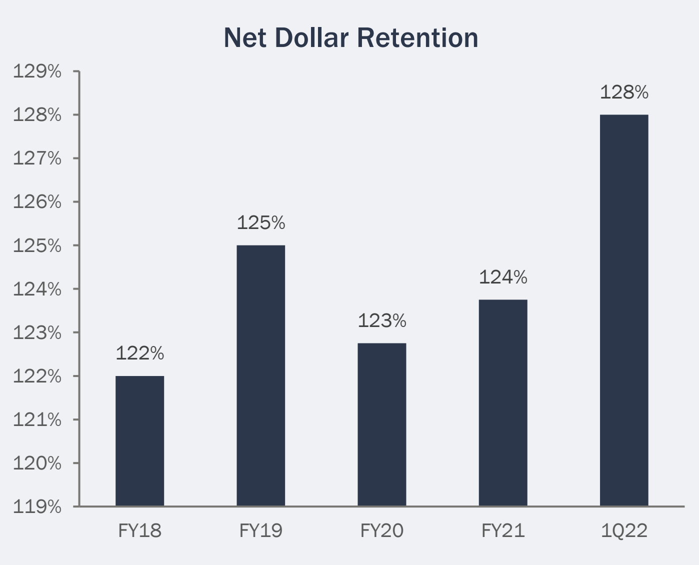
Qualtrics (~3% weighting)

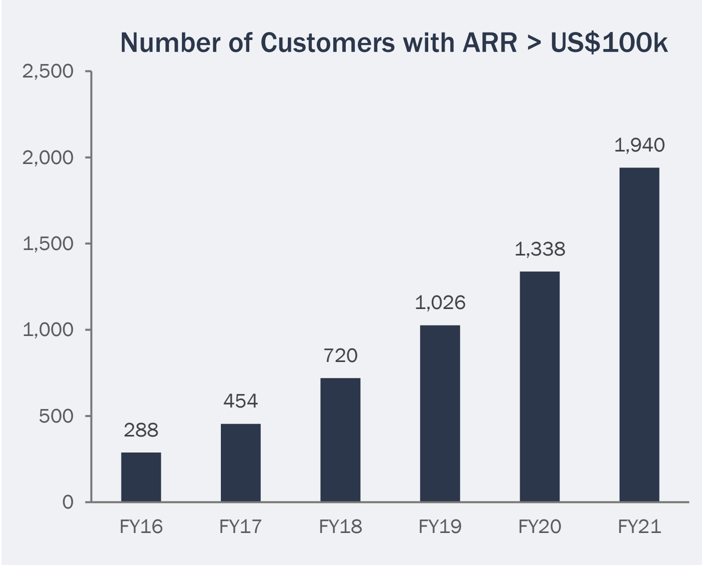
Qualtrics, the leading provider of experience management software, was the third largest detractor from the portfolio return for the past 12 months. The Qualtrics share price has been negatively impacted by the broad de-rating in technology stocks. This de-rating has indiscriminately occurred across both speculative unestablished companies and high-quality technology-backed companies (we believe Qualtrics fits in the latter). Despite this sell-off, our core thesis on Qualtrics remains unchanged; Qualtrics is the global leader in an emerging category, with a technology-driven moat, long runway for growth, and scalable platform-based solution that should allow for significant free cash flow generation. As such, on the back of this de-rating, and no fundamental shift in our core thesis, we have taken advantage of the sell-off and increased our position in Qualtrics over the last six months.

As mentioned in previous letters, our analysis shows that Qualtrics is the world leader in experience management (EM) software. The EM category is one that continues to gain prominence amongst organisations as they look to improve customer experiences, retain employees and outperform their competitors. We believe that these key functions will become even more important in today's volatile macro environment and that EM software will continue to gain adoption amongst enterprises.

Our analysis suggests that Qualtrics' runway for growth is significant, both from an existing and new customer standpoint. Existing Qualtrics customers have consistently increased their spend year-on-year by over 20%, a trend we believe will continue for years to come as customers realise the value an EM solution provides. This increase is driven both by expansion across divisions, and uptake of additional solutions (for example adding the employee solution alongside the customer solution). From a new customer perspective, we believe there is significant opportunity to expand beyond the current customer set, as well as internationally.

Key Qualtrics Metrics





Net Dollar Retention = a metric that compares subscription revenue from the same set of customers across comparable periods and reflects renewals, expansions, contractions and churn; ARR = Annual Recurring Revenue.

Source: VGI Partners analysis.

In our view, Qualtrics' competitive advantage and moat within the EM category is technology-driven. Alongside 20 years of development, and the 2021 acquisition of Clarabridge, Qualtrics has created a highly sophisticated experience platform that easily integrates with an organisation's key applications, collecting, cleaning and analysing experience data. Our research suggests that there are no other EM competitors with functionality near Qualtrics level, and attempts of replication would require significant technological, financial, and time-based resources.

Alongside Qualtrics' revenue growth opportunity and technological moat, we believe the company is at an operating leverage tipping point. Having invested aggressively in Sales & Marketing personnel early in 2022 to support demand, the business is now set up to take advantage of these investments.

We retain conviction in our Qualtrics investment thesis and view the shares as materially under-valued.

Short Selling

The short portfolio was a strong contributor in FY22, delivering **+11%** to returns.[1] The first six months of FY22 were difficult for short selling due to the speculative conditions that persisted and the general willingness to ignore broken business models, accounting issues and industries with structural concerns. However, since late 2021 the short portfolio has provided a strong contribution while also helping to insulate the long portfolio from the broader sell-off. This is exactly why we persisted with short selling even when it was difficult last year, and why we think active short selling is a very important part of the strategy and plays a central role in preserving capital. We mentioned in our last letter that short selling would likely become a larger part of our activities and driver of portfolio returns, and this has indeed turned out to be the case over the last 6 months.

The largest short contributor in FY22 was a custom basket of high-multiple, loss-making technology stocks that we viewed as having broken business models and/or trading on egregious valuations, with the thesis being that valuations for these businesses had room to compress substantially in a higher interest rate environment. This captured businesses such as Affirm, DoorDash, Unity and Rivian. We have since closed out this position as we no longer view the risk/reward as favorable.

The second largest contributors were our short positions in US housing, home building and construction. Towards the end of last year, we formed the view that housing affordability, and in turn housing construction activity, would decline dramatically as a result of rising mortgage rates. Since December 2021, we have seen US mortgage rates nearly double, from around 3% to nearly 6%, which in turn has led to a sharp decline in housing demand (mortgage approvals, housing starts). In an environment where home prices in the US have held up (due to low inventory availability), the negative impact on demand has been particularly acute (had home prices adjusted downwards, we may have seen a step up in demand from home buyers). As part of this thematic, we also added shorts in businesses that were highly exposed to a downturn in residential property investment, one example being the manufacturer of flooring materials that was at one point trading as high as 30x EBITDA. We continue to have a negative view on US housing.

US 30-Year Fixed Mortgage Rate

Source: FRED, Freddie Mac.

Our shorting process has continued to evolve and adapt. The approach of using tailored baskets was something we refined during the year with success. We found this to be of great efficacy by allowing us to express a view across a range of potential targets and narrowing in on our key investment thesis. One example of this was housing and homebuilding discussed above.

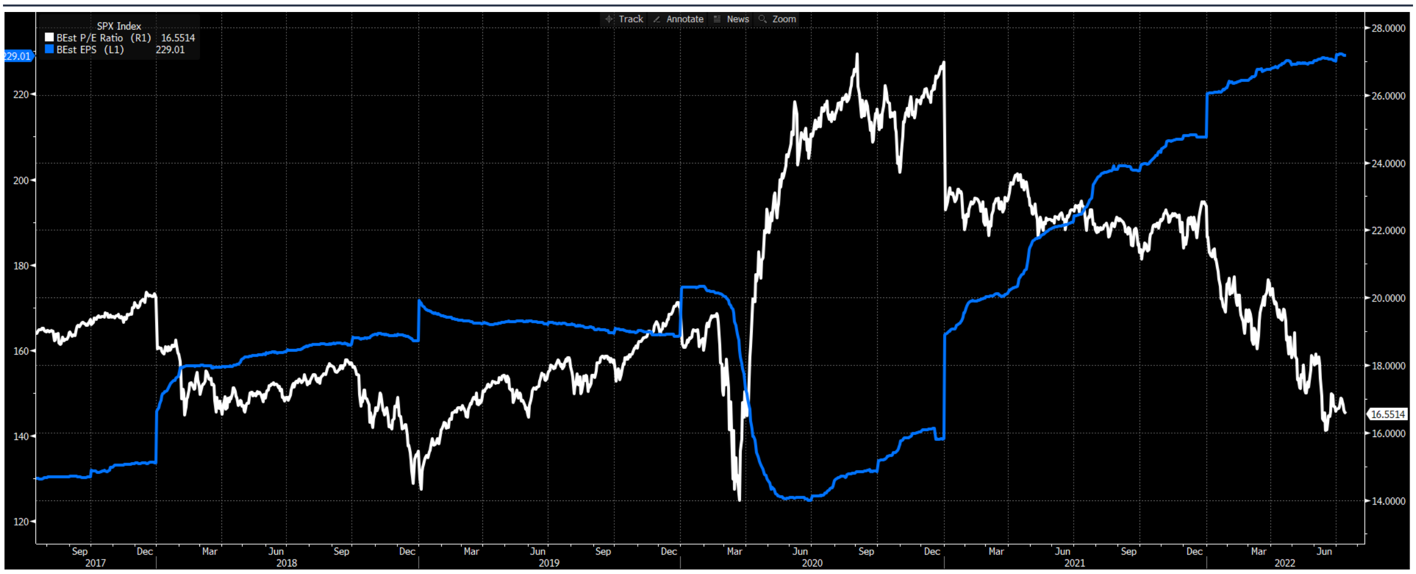
Another example was a short basket that consisted of targets from our proprietary red flags screening process that identifies businesses with both quantitative and qualitative red flags. In the past these screens have had high hit-rates, and indeed during the recent sell-off we were able to use these screens to find various companies that proceeded to underperform substantially.

Another short contributor during the period was a successful short position in semiconductors. Our thesis was that semiconductor businesses were in a speculative bubble as a result of a number of 'market narratives', including the metaverse, which we felt did not reflect a realistic outlook of the industry's fundamentals and ignored both the cyclical nature of many of these business as well as the ramp-up in capacity. Due to the highly technical nature of semiconductors, we elected to short a more diversified basket. While we generally prefer to hand-select more vulnerable companies, we adapt our process to layer in risk management and sometimes prefer to avoid concentration in the short portfolio.

In addition, we experienced good contributions from single-stock shorts. One example was a manufacturer of power tools, whose business had clearly benefited from COVID-driven demand for home renovations. The market had started to extrapolate both revenues and margins well above trend whereas we viewed the business as operating in a competitive environment and likely to suffer from both an air pocket in demand and also margin reversion. The company has already suffered significant multiple compression and some mild negative earnings downgrades, but we believe we are likely to continue to see downgrades given the pressure being experienced by some of its competitors. Another example was a consumer goods company whose product we viewed as a fad, generating an unsustainable level of both revenue growth and margins. Notwithstanding, the market was awarding this business a tech-like multiple despite facing a substantial increase in competition. The stock is now down over 40% since we shorted it and we have closed the position.

We currently continue to hold one of the highest levels of aggregate short exposure we have ever had as we still think there are a number of very attractive short opportunities. While multiples have compressed across various sectors, we are yet to see many companies deliver earnings downgrades. We are finding attractive short opportunities in industries that are still over-earning relative to their pre-COVID levels or industries that we believe will struggle in an inflationary environment. Given the macroeconomic backdrop, we remain cautiously positioned but we will adjust accordingly if our view changes.

S&P500 P/E multiple (white) vs S&P500 EPS estimate (blue)



S&P500 P/E multiple (white) vs S&P500 EPS estimate (blue): while a multiple de-rate has already occurred (from 22x P/E at end of 2021 to 16.5x currently), S&P500 EPS estimates remain at all-time highs.

Source: Bloomberg.

Currency

VG1 is denominated in Australian dollars (AUD) and remains fully hedged to the AUD.

We may move back to an unhedged or partially hedged position – as we take an active view on the currency – but only when we believe there is a clear mispricing based on our fundamental analysis.

In Closing

While we have been disappointed by the investment returns delivered over the last 12 months, we are very optimistic around the current shape of the portfolio and the opportunities the recent market pullback will avail patient investors. As long-term investors with VGI Partners would be aware, we take alignment of interest between ourselves and our investors seriously and our energy and efforts remain focused on maximising risk-adjusted returns over the long term while preserving capital for our collective portfolio. We have a material proportion of our net worth invested in our funds including VG1 and have added to our investments more recently.

While we cannot eliminate short-term volatility from our returns, we continue to retain a high level of confidence in our investment philosophy and process and the opportunities ahead for our portfolio companies. We are profoundly grateful that we have long-term orientated investors who entrust us with their capital and look forward to keeping investors updated.

Once again, we thank you for your investment with VGI Partners Global Investments Limited.

Yours faithfully,

VGI Partners

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