Idea Brunch with Theodore Rosenthal of TMR Capital

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Welcome to Sunday's Idea Brunch, your interview series with great off-the-beaten-path investors. We are very excited to interview Theodore Rosenthal!

Theodore is currently the chief investment officer of TMR Capital, a long/short equity fund he launched in October 2019 shortly after graduating from Johns Hopkins University. TMR Capital has compounded at over 20% before fees since inception with no down years.

Theodore, thanks for doing Sunday's Idea Brunch! Can you please tell readers a little more about your background and why you decided to launch TMR Capital? Has the experience been what you expected?

Thank you for having me! I was born in Charlevoix, Michigan and lived abroad before going back to the States for college. I spent my childhood in Paris and went to high school in Shenzhen. Both my parents were passionate about pursuing their dreams — my mother with art in Paris and my dad with starting several internet companies in Shenzhen. They have inspired me to think big, take risks, and, above all, to win.

I got the investing bug in college after reading *The Intelligent Investor* by Ben Graham. I completed several summer internships in equity research and investment banking and did an off-cycle winter project/internship where I worked directly with an analyst at a long/short activist equity hedge fund. I also traded a lot in college and received a full-time private equity analyst offer but decided to start a hedge fund instead.

I started TMR Capital because I believed and continue to believe that I can generate outstanding performance. The current market structure favors long-

term fundamental analysis focused on identifying inflection points in companies where the future is likely to be very different than the past. Passive investing is now greater than 50% of equity investing and many value investors have suffered large redemptions or gone out of business. Within active investing, a greater share of capital is flowing to investment strategies with shorter time horizons such as quantitative strategies and large multi-strategy or "pod" shops. Dampening monthly volatility has become far more important than generating "private equity-like" 20%+ returns in the public markets. Therefore, investing based on where you think the earnings power of the business will be even just 3 years out and being able to withstand monthly & quarterly volatility is a huge competitive advantage.

As David Einhorn recently put it: "...in the last couple of years I've had the realization that with some of these stocks, nobody's ever going to care. Nobody's paying attention, nobody's doing the work, nobody cares what the company says, there's just nobody home. So we can't make money by trying to buy something three months or six months or a year before other long-only investors figure it out because they either aren't there or don't have any capital or they're turning into index funds."

The returns have been strong so far. Raising capital has been more difficult than expected but I am starting to see traction.

Unlike many early-stage managers, you maintain an active short book. Can you please tell readers about your approach to shorting and share a successful trade or two?

Short selling is important for us and I named one of our investor letters "Dedication to short selling." Our short book has generated positive returns since inception (+6% contribution). Short selling protects our portfolio in down markets like 2022 and gives us additional capital to invest in our favorite longs when markets go risk off.

You're right that a lot of Warren Buffett-type value investors and early-stage managers don't have a large short book. For them, short selling is not a good

use of time because the most you can make is 100% if the stock goes to zero (assuming you don't short more on the way down) and over the long term the stock market goes up.

I disagree. The benefits to short selling are (1) the actual returns and (2) the additional cash I can use to buy my favorite longs. Therefore, if over my investment career, my short book produces a 0% IRR, doesn't blow me up in a bull market and cushions the portfolio in a down market then the efforts towards maintaining a short book would have been worth it. Similarly, if the cost of float for Berkshire Hathaway is 0%, even though 0% is not a good return in itself the float that Berkshire Hathaway generates is incredibly valuable and at 0% doesn't "cost" anything. While the stock market does indeed go up over the long-run, plenty of stocks perform poorly and it's the few big winners that propel the stock market indexes higher. Spending time short-selling enables us to take advantage of the disruption inherent in capitalism while helping us avoid losers on the long side.

I generally classify shorts into the following three buckets: (1) bubble stocks; (2) structurally declining businesses; and (3) over-earning companies. The bubble stocks are not hard to identify. Value traps and over earners require more business analysis.

We successfully shorted many bubble stocks during 2020-2021 that have gone on to decline by over 70%. One example is QuantumScape (NYSE: QS — $5.89 billion) which is a poster child of the bubble at the time in clean energy and SPACs. QuantumScape focuses on the development and commercialization of solid-state lithium-metal batteries for electric vehicles and other applications. In other words, QS is just an idea and does not generate revenue. QS started trading at $10 per share like all the other SPACs and quickly traded to $130 per share in December 2020 for a $50bn+ market cap. GM had a $50bn market cap and generates over $160bn in revenue. QS now trades at $13.27/share. Every time a revolutionary technology comes out that will change the world, a bubble forms and many of the start-up companies involved end up going under. For example, the internet was very real but 86% of the dot com companies went

bankrupt. It’s no different with the clean energy revolution. While QS may end up thriving, a basket of 50 shorts just like QS will end up being a very good short basket.

Varta AG (Frankfurt: VAR1) is an example of a successful short of a company that was overearning. Varta sells microbatteries and energy storage solutions worldwide. Varta went from growing revenue LDD in 2018 to growing revenue 33% in 2019 and 138% in 2020 with EBITDA margins expanding from 16% to 25% and EPS going from $0.76 to $2.88. Varta went from trading at 2.5x NTM Revenue to 7.5 times. Varta benefited from in our view an unsustainable first-mover advantage in lithium-ion batteries used for True Wireless Stereo (TWS) wireless earbuds. As the market growth and TAM potential for wireless earbuds exploded after Covid, more suppliers entered the market and we believed the increased competition would erode Varta’s pricing power because Varta has no competitive advantage over cheaper Asian suppliers. Our variant view was that pricing and operating margins would decline. Varta’s revenue growth declined in 2022 and earnings went negative. The stock declined 90% from the peak and Varta now trades at 1.6x NTM Revenue.

Many talented young investors launch funds hoping to outperform the markets, but end up posting lackluster returns. Why will you be able to outperform over the long run?

Because I have a behavioral edge and a differentiated process/investment philosophy.

Regarding my behavioral edge, I have a longer time horizon than most public market investors and can withstand more monthly and quarterly volatility (assuming the portfolio does not have overly high gross exposure and lots of factor mismatch between longs and shorts) which enables me to both be more opportunistic and gives me more staying power. I came to fully appreciate this behavioral edge when I was trading in college and invested in Fiat Chrysler based on a highly differentiated view of the earnings power of the business 2-3 years out. I shared my research with a portfolio manager at a large multi-

manager who thought my fundamental case was compelling. However, over the next three months, the stock fell 25% and the PM emailed me “stock down 25% - what did I miss?” The PM explained that in real life this position would likely have to be trimmed or exited for not “acting right.” The stock went on to quadruple over the next 18 months and the earnings power evolved as expected. Since I didn’t have to worry about dampening monthly volatility, I was able to see that the fundamentals did not change in that three-month period.

Businesses that meet my qualitative and quantitative criteria can become temporarily dislocated because investors have overreacted to negative macro or company-specific events that will have little to no impact on long-term intrinsic values. This “time arbitrage” gives me an edge and because the inefficiency is behavioral, this advantage is enduring and provides me with a repeatable process/edge.

To quote some notable investors regarding this time-arbitrage:

“The single greatest edge an investor can have is a long-term orientation.” — Seth Klarman

"I think one of the inefficiencies in the market is investors are generically too short-term oriented and time arbitrage is one of the best inefficiencies in the market." — David Einhorn

Regarding my process/investment philosophy, I am interested in big changes/companies going through major inflections where the future is likely to look very different than the past. This opportunity set is where the multi-baggers are because the stock can benefit from both multiple expansion (as the market better appreciated the story and big change taking place) and earnings expansion. These types of inflections are also less correlated to the market and could be at the business level (new product, product mix shift, change in philosophy away from growth at all costs and focus on profitability, etc…) or at the corporate level (spinoff, companies emerging from bankruptcy, M&A, etc…).

What are two or three interesting ideas on your radar now?

I'm excited to share three of my top ideas with your readers!

1/ Long: IAC Inc (NASDAQ: IAC — $5.82 billion)

IAC is my largest long position. I view IAC as the anti-Berkshire Hathaway of technology/media. They have a unique portfolio of premium internet assets with significant growth potential including industry-leading businesses in three large categories (Home Services, Digital Publishing, Care) and IAC has been one of the great shareholder value creation/capital allocation stories since 1995.

Right now, IAC is facing a perfect storm and valuations are as depressed as they've ever been. In the short-term, this is a multi-bagger and in the long-term, it can compound at 20%+.

Fast-growing consumer & tech businesses (especially unprofitable long-duration ones) are out of favor. However, investor preferences are cyclical.

Its largest business, Dotdash Meredith, formerly just Dotdash, is going through the integration process after acquiring Meredith, which is causing a lot of noise in the financials and is a couple of months slower than expected. They are also suffering from a weak ad market. Both issues are temporary.

Angi, also a significant business is facing challenges of its own. On the one hand, it's the dominant home services marketplace, on the other hand, its EBITDA margins went from 22% in 2018 to barely positive now. They seem to be mis-executing on their initiatives to shift towards a fixed price procurement model (which looks to be lower gross margin but should be more S&M and G&A efficient) and away from a marketplace/lead generation model. They are also combining all their products into one brand which is currently making their S&M less efficient. The CEO of IAC, Joey Levin, has just taken over as Angi CEO. Angi continues to be the dominant player in a structurally growing industry.

With a normalization of the business's revenue, earnings trajectory, and valuation multiple, we comfortably get 365% upside by 2027 for a 38% IRR. A SoTP results in similar upside potential.

To give you another idea of how cheap IAC is, if you strip out the value of ANGI and MGM (both publicly traded) there is $228mm left for the stub. For $228mm you are getting:

- Dotdash Meredith: which did almost $2bn in revenue in 2022 and should have 20%+ long-run operating margins (high-margin advertising and subscription revenue).
- A 31% stake in Turo: the largest peer-to-peer car-sharing marketplace. IAC's stake in Turo is c.$350mm at cost and likely worth 3x-4x that amount.
- Care.com: In 2019, IAC opportunistically acquired Care.com for $500mm and Care is likely worth significantly more now as the business has been rightsized and is growing.

At a TD Cowen conference in June 2023, IAC's valuation was discussed:

"So we — on our numbers as of like yesterday, ex MGM, Turo at cost, other items. We're looking at a 1.5x EBIT, EBITDA on our '23 estimate." — John Ryan Blackledge TD Cowen, Research Division

2/ Short: BJ's Wholesale Club Holdings (NYSE: BJ — $8.87 billion)

BJ is a Warehouse Club chain that primarily sells groceries (71% of sales), general merchandise (14% of sales), and gas & ancillary (15% of sales). Their core value proposition is selling groceries at a discount relative to conventional grocers.

BJ has been one of the largest beneficiaries of the COVID-driven stay-at-home boom and the deurbanization trend. Furthermore, prior to the pandemic, BJ was a clear market share donor and the company's SSS ex. gas were negative in every year from 2013-2017. SSS only inflected to a positive LSD% rate in

2018-2019 when Walmart moved to close several Sam's Club stores in BJ's core geographies.

Both drivers of SSS are transitory and BJ continues to face intense competition in a low-growth industry. Unless SSS re-accelerates (unlikely), the upside is already priced in. BJ is already trading at peak multiples on what is likely peak earnings and trades nearly in line with best-in-class staples retailer Dollar General despite lacking the historical growth track record that Dollar General has.

The rapid expansion of hard discounters Aldi and Lidl in BJ's core geographies represents an existential threat to BJ's business. When Aldi and Lidl entered the UK, the big 4 conventional grocers (Morrison's, Asda, Tesco, Sainsbury's) ceded 10 percentage points of market share which led to 25%+ declines in EBIT. In addition, we are seeing continued market share gains from Amazon Fresh and Costco.

As food inflation and pandemic gains level off, investors will shift their focus to the competitive landscape. We think that comparable sales will start to decline and that EBITDA margins revert to 3.3% (where they were before Covid and before when Walmart closed their competing Sam's Club stores). 10x our 2024 EBITDA results in 25% downside.

3/ Long: Sprott (NYSE: SII — $813 million)

Sprott is an asset manager focused on natural resources. About 2/3 of their revenue comes from management fees and they have $25 billion in AUM, of which $19 billion is in exchange-listed products.

Sprott is an attractive way to play a bull market in natural resources/gold/silver. When a bull market in gold/natural resources gets underway, many investors would prefer to gain exposure without having to take the political and geological risk of owning miners or E&P. Therefore, they will pay a premium to invest in ETFs that provide that exposure. We can gain exposure to the natural resources bull market by investing in a high-margin asset manager where there

are multiple ways to win: bull market in natural resources and the operating leverage that comes with increasing AUM and high-margin recurring revenue streams.

We think that AUM can increase to $60 billion by 2027. EBITDA margins would expand from the operating leverage that comes from increasing management fees. We have EBITDA margins expanding from 40% to 67%. 15x 2027 EBITDA results in 340% upside for a 37% IRR.

(TMR Capital is currently long IAC, long SII, and short BJ in the fund)

Theodore, what are some of the first things you do when researching a potential investment? What does that first hour of research look like for you? Do you do anything that few others do?

I have three categories in mind when researching a potential investment: (1) should I add this company to my watchlist; (2) is there an inflection in the business that will cause the future to be very different than the past; (3) is there already some kind of dislocation such as an extraordinary corporate event or the entire sector/factor is out of favor and there may be babies being thrown out with the bathwater.

For (1), on the long side I am looking for quality compounders (both currently profitable and emerging compounders that are growing quickly but not yet profitable) and on the short side, I am looking for structurally declining businesses. Even if the valuation isn't yet compelling and there is not much debate regarding the stock, I will add the company to my watchlist and follow it if it meets my criteria. For (2), I am looking for the potential for big change that is underappreciated by the market. Some examples would be looking for evidence of a dramatically different competitive environment, new product introductions, a controversial story, and a profound change in management philosophy/capital allocation. For (3), I will start with the dislocation such as spinoffs, companies emerging from bankruptcy with a new balance sheet and where the competitive dynamics of that industry may have changed, or in areas

of the market where sentiment has changed quickly and dramatically such as right now with fast-growing but currently unprofitable consumer and technology companies which went from being market darlings to utterly hated in a short period of time.

With those filters in mind, when I start researching a company, I will look to get familiar with the business by reading its filings and analyzing the financials for the business and its competitors. I will then want to speak with other investors to better understand the stock and the bulls vs. bears debate and with industry participants to better understand the company and industry. Ultimately, I want to boil down the investment thesis to just a few fundamental points that will move the stock and have a differentiated view on those 1-3 points.

What would you like TMR Capital to look like 10 years from now?

I have virtually my entire net worth in TMR Capital. The objective is to generate hall of fame returns while keeping risk under control. I will be disciplined in growing AUM to have the necessary resources while not getting too big as to dampen returns. Therefore, 10 years from now, I anticipate that TMR Capital will still be a single-manager shop with a small research team of analysts covering a particular industry from a long/short perspective as well as a dedicated short-selling team more focused on the bad accounting/fraud angle. I have also recently been making more of an effort to build relationships with other investors and industry experts which will help in the investment process.

Theodore, thank you for the great interview! What is the best way for readers to follow or connect with you?

My email is ted@tmr-cap.com and I would be happy to add accredited investors to my email distribution list.

Guest disclosure: "The information in this interview is not personalized investment advice or an investment recommendation on the part of TMR Capital LLC; nor should any portion of the commentary included herein be construed as an offer or the solicitation of an offer to purchase any security or other

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