Dear Investor,

The Spree Capital Advisers Composite Index declined 29.22% net of fees in the first quarter of 2020.

Spree Capital Advisers Returns vs. Indices														
	2019	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	YTD
Spree Capital Advisers	25.27%	-4.66%	-10.10%	-17.42%										-29.22%
S&P 500 Total Return	31.49%	-0.04%	-8.23%	-12.35%										-19.60%
HFRI EH: Fundamental Growth Index	13.74%	-0.32%	-2.63%	-9.10%										-11.78%
Barclay Hedge Fund Index	10.64%	-0.18%	-2.85%	-8.84%										-11.60%
Barclay Equity Long Bias Index	15.28%	-0.77%	-5.07%	-11.31%										-16.43%
Barclay Equity Long Short Index	6.59%	-0.67%	-2.21%	-6.07%										-8.76%

Q1 Review

The first quarter of 2020 began with the resolution of a trade war and the adjournment of a presidential impeachment probe. Then, between February 19th and March 23rd, a series of crises unfolded. In rapid succession, the worst global pandemic since 1918, the largest oil price decline since the founding of OPEC in 1960, supply shocks from the fracturing of global just in time supply chains, government mandated shutdowns of entire economies, demand shocks from quarantined consumers and shuttered factories, and finally, a labor market collapse, all conspired to send equity markets down between 33.7% and 40.7%, the quickest such decline in history. Over the course of just twenty two days, businesses with pre-existing comorbidities of fixed cost leverage and financial leverage were exposed to virulent demand shocks that caused many businesses to go from having record revenues and earnings to facing bankruptcy.

In accordance with our strategy, we did not own any businesses in the airline, cruise line, energy, gaming, restaurant, retail, or real estate sectors. As it became clear that COVID-19 was spreading in Italy and thus was not just an isolated Wuhan problem, we exited two small positions that had end markets exposed to mass gatherings of people. We re-underwrote all of our businesses for a COVID-19 world, and made several small investments in businesses we had been tracking that stand to accelerate customer adoption in a social distancing environment. Nonetheless, when a once in a hundred year pandemic forces entire economies to completely shut down, the resulting panic and widespread financial market liquidation caused the prices of many of our businesses to decline.

While the prices of many of our businesses declined, the sales and earnings growth outlook over the next one, three, and five years, and thus the intrinsic value of our businesses, were not meaningfully impacted. We are invested in scalable business models supported by long term secular tailwinds, run by management teams with an ability and willingness to reinvest cash flows at high incremental returns on invested capital. A one quarter economic shutdown is insignificant to the growing cash flow streams that will compound shareholder value in the coming years. Additionally, in businesses that represent a majority of our portfolio exposure, we believe that the multiple crises in the first quarter will expedite the process of pushing consumer acceptance further along their respective adoption curves.

When we think about the many implications of the series of crises on the investment landscape, we believe that Andy Grove said it best: “Bad companies are destroyed by crisis, good companies survive them, great companies are improved by them.”

Bad companies are destroyed by crisis. One key part of our strategy is that we avoid investing in industries

and business models with cyclical end markets with punitive hidden leverage inherent in a high fixed cost structure. Fixed costs constitute hidden leverage in a business model in that they are born irrespective of sales, as the fixed assets behind the fixed costs are not consumed in the normal course of unit production or services rendered. A demand shock such as the one from COVID-19 causes funding deficits in a business to quickly multiply as a result of diminished cash inflows from a decline in sales, while the fixed costs of servicing a businesses' fixed assets remain. Financial leverage put on a business based on overly optimistic expectations for a steady increase in sales over the medium-long term means that any decline in operating activities, especially in conjunction with a high fixed cost structure, can dramatically increase the volatility of earnings as the business has to cover the costs of servicing fixed assets and continuously accruing interest costs. This problem is exacerbated when the fixed costs and financial debt comes due, but the value of the assets backing the debt is meaningfully impaired. This reliance on capital markets then necessitates emergency funding that primes the equity, often substantially impairing the equity value.

While the Covid-19 government mandated economic shutdown was an unknown unknown event, our reasons for avoiding many sectors and business models are the same as the ultimate effects of the shutdown. Cyclical businesses with preexisting comorbidities of a capital structure assembled based on persistent sales growth expectations with no margin for error and no ability to flex costs to right size operating structures are often a recipe for permanent capital impairment.

Great companies are improved by crisis. A great company is one that has dominance in its niche, is led by a proven management team with clearly defined strategies to maximize shareholder value, and has the resources, culture, and expertise to execute over the long term. We look at many criteria in assessing what makes a great business, but in the midst of the COVID-19 demand shock, among the most important is a strong balance sheet. We view the strength of our businesses' balance sheets in relation to their competitors, the industry outlook, and the companies' opportunity set. A self-funding business model that is not reliant on capital market access is an important part of this criteria. The combination of a strong balance sheet and a self-funding business model helps our businesses in two ways.

First, having the financial strength of a strong balance sheet and a self-funding business model mean that our businesses are able to look at the multiple crises we are in as a source of opportunity to help serve customers. The ability to outperform competitors as they adapt to change means that our businesses can cherry pick high return on invested capital opportunities to use internally generated cash flows to reinvest in the business while financially fragile competitors are forced to cut back on growth investments. Having the capacity to source and execute on opportunities to help customers in a crisis comes from having the financial wherewithal, but also from having a proven management team and culture of successful execution. We are teaming up with management teams who have sourced opportunity and executed well before and are in the position to do it again.

Second, a self-funding business model backed by a strong balance sheet means that our businesses stand in position to be liquidity providers to levered subscale competitors. This is relevant in situations where there are opportunities to consolidate fragmented industries, and in situations where there are uneconomic growth at any cost startups. We have fifty two percent of our portfolio invested in highly fragmented industries. In these situations, our businesses represent the scale player in their respective end markets, and have superior balance sheets and internally generated cash flows that enable them to consolidate the industries as competitors exit. We have forty four percent of our portfolio in industries where our businesses compete with uneconomic startups. These businesses lack the unit economics and scalability to compete with our businesses. As the funding environment softens, we believe that our businesses will have many opportunities to gain market share.

Our portfolio of scalable businesses have strong balance sheets and internally generated cash flow to fund high return on invested capital initiatives to serve their customers in this time of crisis. As it relates to COVID-19, we do not have any businesses directly impacted by the government mandated shutdowns, but for the businesses we have that do have second derivative effects, as they improve their product and further perfect the rails on which the scalable business model operates, future shareholder return is increased for when the secular demand returns to being a tailwind.

Our Undiscovered Compounder strategy detracted 24.10% from our net return in the quarter. This strategy consists of great businesses led by proven management teams with clearly defined strategies to maximize shareholder value. Our Undiscovered Compounder watchlist currently has forty five businesses in the funnel, not including the five small investments we made in the quarter.

Our Value with a Catalyst strategy detracted 5.12% from our net return in the quarter. This strategy, which consists of good businesses with near term catalysts to rectify the misperception that depresses the valuation, in normal times provides ballast to the portfolio from factor betas that temporarily impact the core Undiscovered Compounder strategy. The opportunity set in this beta hedging strategy is currently limited, but we expect that to change meaningfully in the coming quarters as ill prepared companies restructure business lines and sell or spin off non-core assets, and companies with fortress balance sheets ramp up their acquisition activities. Currently, our Value with a Catalyst watch list currently has seven businesses in the funnel.

Conclusion

In our Q4 2019 letter, we wrote that "Risk is what one does not see, and the work that we do every day is to prepare for opportunities when great businesses are offered at discounted valuations based on transitory market pressures." We were not referencing a potential global pandemic when we wrote that, but the effect on our process is the same. Our focus on finding, vetting, and tracking great businesses with secular tailwinds and long runways to reinvest cash flows typically presents episodic single business investment opportunities. The global pandemic and its many impacts has caused many of the businesses we follow to be offered at attractive discounts to intrinsic value. This has created great opportunity for the long term investor, and we plan to be increasingly active as a sustainable path out of this global pandemic becomes visible.

The most formidable barrier to compounding returns over the long term is resisting the urge to panic in the face of temporary price declines when the intrinsic value of the business is unchanged. In times of crises such as these, the best margin of safety against permanent capital loss and the risk of panicking out of an investment is owning great business models backed by strong balance sheets, run by superior management teams, and with sufficient internally generated cash flow to reinvest in high return on invested capital opportunities. This combination enables great businesses to adapt to changing customer needs, take market share, make tuck in acquisitions, and continue on their path to growing sales and scaling the business to improve cash flow and shareholder returns. Having this North Star to guide us helps to tame the psychological biases which threaten to prevent the magic of compounding from delivering outsized shareholder returns over the long term.

We thank you for your continued confidence in us as the stewards of your capital.

Sincerely,

Thatcher Martin, CFA

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