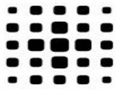

Good Investing
Understanding businesses & Connecting investors

What do all highly successful investments share? Thatcher Martin (Spree Capital) on eBay & Upwork

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Transcription

Introduction

[00:00:00] Tilman Versch: Hello! Today is a great day because I have Thatcher Martin of Spree Capital on. As a German, I'm naturally curious why you've chosen the name Spree Capital. I think about a bit of a crazy theory. Let me try if this might be true, but I'm curious to hear the explanation as well.

Origin of the name Spree Capital

So, you're a Ramstein fan, but you didn't dare to take the name of Ramstein for your firm, so you're thinking about the city where the band comes from, that's Berlin, and there's a river Spree. Does it have something to do with the name Spree Capital, or I'm wrong?

[00:00:38] Thatcher Martin: Sadly no. My grandfather had a boat named Spree. He really had two loves in his life. It was his family and the ocean. When you're raising a family, your finances are constrained. He had an opportunity to buy a boat that had been badly damaged by a fire under the stewardship of the previous owner. He bought it and spent years restoring it by hand. I thought that was an excellent allegory for what I'm doing here: finding high-quality, undervalued, and misunderstood assets. With some kind of tailwind, they can provide a lifetime of value. Sadly, it is not related to the German river, but it's something special to me.

[00:01:34] Tilman Versch: Is this boat still existing?

[00:01:37] Thatcher Martin: No. He has since gone up, so, no.

His minimalist website

[00:01:42] Tilman Versch: That's sad, but it's a fascinating story. When I came about studying your materials on your website, I was fascinated because it felt a bit like the way you presented yourself on your website was super minimalistic. You have some sentences there, some bullet points, and more comprehensive reports on different companies. It was evident that these reports of the companies show hard work, deep work. Do these two categories, minimalism and hard work, describe you?

[00:02:24] Thatcher Martin: Sure. I think so. In terms of the minimalism of the website, it's a landing page. I do not do any form of marketing for this firm. Anyone who happens to read the letter and see something they like can go to the website and contact me that way. When running an investment firm, it is so important to have investors that are aligned with your way of thinking, your investing style, and are partners for the long term.

I set it up in a way that there was a self-selection process where the investors that are coming on board agree with what I'm doing and with the minimalism of the website they can see what I'm looking for in investments and they can be self-selecting. No one is being “sold” on anything.

Saying "no"

[00: 03:25] Tilman Versch: I like the concept of minimalism because it gives a lot of clarity. It also offers a strong will to say no to many things. To what things are you saying no with Spree Capital and the way you approach investing?

[00: 03:42] Thatcher Martin: I say no to a lot of things. I only have about 20 businesses in the portfolio, but I perform the research process on many businesses. It is a high bar to make it into the portfolio. I am saying no to almost everything.

Saying "yes"

[00: 04:04] Tilman Versch: What are the ingredients for you to say no and say, "I'm not interested in this."? You can also turn this around to, what makes you say yes?

[00: 04:17] Thatcher Martin: That is probably an easier question to answer. When I think about investments that might have a role in the portfolio, I look for eight key things.

First, I look for repeatability in the business model. This can be a consumable product or service. This can be a business with dominant scale in a fragmented industry and a proven process for sourcing, acquiring, and integrating mom and pop type operators and putting them on a common platform to enable geographic expansion and densification.

This can be a Model-Driven business with some closed customer feedback loop, where the business is able to monitor the way the customers use the product in a way that creates data which helps the business iterate and improve the product and add ancillary products, which drives a flywheel of more customers, more data, better products, more customers, and it perpetuates itself.

Part of repeatability in the business model, I'm looking for a culture that allows the business to adapt to change. That can mean some set of common principles or attributes that permeate through the organization. This is so important because when different messages get handed off throughout different layers in the organization, it's like a game of telephone where the message changes throughout the process. Unless the culture is strong enough, the business does not operate on the same playing field throughout the organization. A strong culture helps the business move faster, iterate faster, and create better products.

Second, I look for predictability in the path to value creation. In other words, no undue complexity. I am comfortable with complexity in certain business models that might be misunderstood, but the actual path to value creation has to be very simple and non-complex. I think about that in terms of the Nate Silver story about how you can be a weather forecaster in Denver or Phoenix. Why not just predict the weather in Phoenix at 85° and sunny every day? I am trying to be right. I am trying to generate high returns. I am not trying to have some situation where A has to happen, then B has to happen, and then C has to happen in that order. At each iteration of those three nodes, there's a lower conditional probability of the ultimate outcome happening. I am looking for simple paths to value creation that can be predicted.

Third, I am looking for growing end markets. The bottom line is that the pie has to be growing. I am not looking for static or shrinking end markets, where there's a fixed pie and competitors are fighting for share and maybe making irrational decisions. The size of the end market has to be growing. Ideally, that is from the companies own volition. In other words, the company is creating that end market, or at the very least growing it. Part of that is that anytime you have a new or misunderstood market, there's almost always some information asymmetry. In new markets that are not properly understood, businesses tends to trade at pretty attractive valuations. You saw that in the IPOs of Google, Chicago Mercantile Exchange, MasterCard, Moody's, and in some of the businesses I have in the portfolio. As part of the growing end markets, the industry structure itself has to be an industry structure where value creation is possible. Going back to how I say no, it pretty quickly eliminates certain sub-sectors in energy, materials, financials.

Fourth, I am looking for increasing returns to scale. The way I think about that is you have supply-side scale where the cost per unit declines as production grows, provided there's no kind of input scarcity or undue bureaucracy in the business. Demand-side benefits of scale involve combinatorial networks where there's a network effect, and each additional user makes the

network stronger for everybody. Each user is willing to pay more for that network. That is something that I am much more interested in than the supply-side benefits of scale. Both of those are important to me because operating leverage is almost always mispriced because investors succumb to anchoring where they are biased by the past margin structure of the business. They are biased by linear thinking in terms of very few institutional investors are able to think in terms of step changes in a business model. They are biased by social proof in that it is always better to succeed conventionally than risk failing unconventionally. In other words, no analyst will be rewarded for having an outside-the-box belief in their model and showing that to the fund manager. Those three institutional imperatives tend to skew outcomes in our favor. And they're part of the reason why operating leverage and increasing returns to scale are almost always mispriced. I think about the path to operating leverage in terms of what costs are one time in terms of starting up the business and what will decline over time with scale. That is how I think about increasing returns to scale.

Fifth, I look for a long runway of a high return on invested capital opportunities. This is so central and key to any high-quality business because most growth does not create value.

The return on invested capital has to be far in excess of the cost of capital. I like to see businesses that are self-funding. Growing end markets tie into this because if there's a growing end market and the business is self-funding, those high return on invested capital opportunities are prevalent. When that business has low penetration and a large growing addressable market, that is just such a great enabler of using internally generated free cash flows to reinvest in new product initiatives and new niches that they are able to identify with, back to what I mentioned before, the closed customer feedback loop.

In terms of how I think about that, technological adoption curves are great. They create a backdrop for growth, but you have to connect dots from different parts of the business and other businesses and other industries to think about how certain consumer trends might play out. Sometimes it is different opportunities and products that might not even exist yet. There is an innate aspect to quantifying some of those ROIC opportunities.

Sixth, I look for a catalyst. I look for some changing dynamic that unfolds over a multi-year period. This can be technological. This can be managerial. This can be regulatory. There is some inflection point in the path to value creation for the customer base and the business.

Seventh, I look for a competitive advantage that is growing. This is the direction of the moat. It's not necessarily the size of the moat. The way I think about that is that having a large moat is great for a business that does not change, but there are so many disruptive business models out there coming from every direction. Going back to the Moat and Castle analogy, you can have a great castle with a great moat, but if a new castle is built right next door, it can starve the supply line of customers. You don't even have to attack that moat. It is just rendered useless through disruption. It goes back to the old adage that competition is for losers, you want to differentiate. For me, it is really about a growing competitive advantage, not necessarily just the size of it. As it is growing, I want to see a large one getting larger, but any kind of large one that is static is not meaningful for me.

Eighth, I look at valuation. The way I think about it is a lot of people think about valuation in terms of this business is trading at ten times earnings or ten times sales. That really tells you nothing about the valuation of the business. All the numbers are in the past, and all the value is in the

future. Valuation only depends on the present value of future cash flows, and ten times earnings or ten times sales tells you absolutely nothing about what the earnings power of the business is in two to three years out. Investing based on the past is going to get you killed.

At a minimum, I'm looking at 18 months out into the future, ideally, two to three years or more because my holding period tends to be pretty long. I look for a margin of safety, but not in the way that a lot of people think about the Graham and Dodd margin of safety where you go through the balance sheet and assign a liquidation or replication value for every line item of the balance sheet. For me, it is much more about the permanence of the business and how the growing competitive advantage translates into growing earnings power. To get that, you need to have a deep understanding of the business and the paths of value creation to enable that ability to buy at a deep discount to the expected future value of those cash flows. Then, of course, unit economics and how the economics look on a per unit basis over a variety of different playbooks, CAC and LTV and all that stuff. That's kind of why I might say yes to an investment. If it doesn't satisfy those needs, that would be why I say no.

First career steps

[00:17:09] Tilman Versch: Maybe let's try to zoom a bit out this clear philosophy, and this clear checklist of eight things needs a lot of work till you come to this point. It's also a lot of experience in the industry and in investing. What did you do before the test led you to this clarity and this concept? What did you learn in these different stations you had already in your life because you seem to be a bit more senior than the typical emergent manager?

[00:17:46] Thatcher Martin: Sure. I first started investing when I was pretty young. I had a paper route when I was in elementary school. After a few years of doing that, I had saved up a little bit of money. I was close with my grandparents and noticed that they had pillboxes with their daily prescriptions. I put my life savings into Pfizer because I liked that they made medicine that helped sick people. Around the same time, my parents started a college savings account for me. My dad had some domain knowledge in industrial distribution, and he invested in a company called Airgas.

I had my Pfizer, and then there was Airgas. The dollar amounts were similar in that they were pretty modest investments in both. Fast Forward to when I was ready to go to college. Pfizer had done okay, but the Airgas was a multiple 100 bagger. It is a great case study for anyone who does not know that business. They followed a Standard Oil, and a lesser extend Walmart and a few other businesses' playbook of geographic expansion by buying regional anchors and then infilling through M&A by acquiring two to three businesses a month. There was this large number of aging out World War II-era mom and pop entrepreneurs where their kids did not want to run these businesses.

They rolled up industrial gas distribution and then later medical gas distribution. Fast forward to when I was going off to college, my Pfizer did okay. This business had fantastic returns. I was always intrigued by the fact that similar dollar amounts could have such drastic changes in outcome. That was always percolating in the back of my mind. I went off to college and studied economics and psychology.

Professionally, I cut my teeth at a firm called Gracie Capital. And Gracie had spun off from Gotham Capital, which was Joel Greenblatt's hedge fund. We invested in the Greenblatt style of value with

a catalyst investing. This could be spin-offs, demutualizations, really any kind of change that was likely to be regulatory, managerial, or technological that created some kind of disruption in the path to value creation.

I was ultimately there for about eight years. It was a fantastic apprenticeship for me in that I was able to be a sponge, learning from some really great investors and taking a lot of what I learned, and tweaking it in a way that was best suited for my personality. I kept going back to these two investments that I made when I was very young, and the drastic difference in outcomes. The typical hedge fund style is you're grinding out returns, there's a lot of turnover. You are trying to get that high teen CAGR, but you are leaving a lot of good returns on the table by trying to come up with new ideas, new names all the time. If you think about the businesses that generate real returns, I am not talking about high teens churning through business. I am talking about really high caliber returns of 20% a year over 20-30 years. Businesses like Amgen, Microsoft, Heico, Home Depot, Nike, Constellation brands, Constellation software, Adobe, Danaher, the list goes on. There is not a lot of them, but that is really what I am looking for in the criteria that I went through, the eight things that I am looking for, the business with a really long runway to generate very high returns over the long term.

Building a firm

[00:22:29] Tilman Versch: At a certain point, you said, I have to invest for myself and have to find a structure where I can follow this passion. Is that what drove you to make Spree Capital?

[00: 22:40] Thatcher Martin: That is correct. I worked at some great places, but ultimately, I felt like my process and style were uniquely my own. I was very interested in starting a firm and growing a firm in an investing style that I think really works over the long term. I started with a blank slate and took all of my learnings and my process and launched. That was January of 2019. I am now almost three years in.

Forming investing process

[00: 23:32] Tilman Versch: How did you go about it? Did you just cross the line and stop being at the hedge fund? Did you go, "Now I go fully into Spree Capital."? What was your way of building the firm?

[00: 23:46] Thatcher Martin: I took a few months in 2018 to get the firm up and running. You have to be registered. I set up an LLC and stuff like that. It takes some time, but the process and systems that I am using were curated over my whole career. No part about my actual process was newly invented here. It is just that sometimes when you are working for a fund and a fund manager, you are a hired gun. You are subject to external decision-making. My process enables me not to be subject to some institutional imperatives that do not always work best for long-term value creation.

Time management

[00: 24:50] Tilman Versch: How did you build Spree Capital as a company that supports pursuit for finding high-quality business, and it in itself is also high-quality business for the different shareholders or stakeholders?

[00: 25:06] Thatcher Martin: I set it up in a way that made it so I can spend 99% of my time researching businesses and managing the portfolio. What that means is--.

[00: 25:24] Tilman Versch: You have to show this magic formula for the 99%. That's a high rate.

[00: 25:28] Thatcher Martin: Well, it is not as hard as it sounds because I have a custodian that handles all the administrative tasks. I do not have to deal with any of that. I do no marketing. The idea that investors who believe in the vision and believe in the returns and the businesses that I am investing in self-select and find me. That just cuts out so much time and effort for going to conferences and such to raise money. I want investors that are long-term oriented and really believe in what I am doing and what is happening here. Thus, that 99% is pretty easy to stick to.

Investors of Spree Capital

[00: 26:26] Tilman Versch: What kind of investors are you building Spree Capital for? Or let me turn it around a bit. What kind of investors has found you because you're building it this way?

[00: 26:36] Thatcher Martin: Sure. It was friends and family and former colleagues. People that I knew and had relationships with at the start.

[00: 26:44] Tilman Versch: The only crazy ones to support someone who wants to start something.

[00:26:48] Thatcher Martin: Exactly. People that knew some of my previous returns and had confidence enough to put their checkbook on the line. From then, it has been people that maybe were forwarded my letter by an existing investor and came on board that way. I expect that certainly, in short to medium-term that continues.

[00: 27:21] Tilman Versch: Can you disclose a bit who finally found you then over the years?

[00: 27:25] Thatcher Martin: Sure. It is high net worth investors, some family offices, and then endowments. Those decisions take a little bit longer. They want to have conversations every quarter. I am three years into something that I am going to do for 30 years. I have no problem growing slowly and growing the right way.

[00: 27:56] Tilman Versch: That's great to hear. You mentioned your previous returns before you started the firm. Can you maybe give a little bit of an idea of how you managed your own money before that?

[00: 28:08] Thatcher Martin: I have been compounding the returns at Spree at about a 39% CAGR over those three years. Before that it was lower, but that the whole point of launching your own firm is that you can do things that are not subject to interference that might disrupt returns. The businesses that I am looking for, when I listed off the Microsofts, Amgens and such, the businesses that I am looking for tend to compound at pretty attractive rates.

Mistakes

[00:28:51] Tilman Versch: Are there any investment mistakes when you look back in your investment career before starting Spree Capital that has taught you a lot?

[00:28:59] Thatcher Martin: Yes. My hindsight book has compounded magnificently. There are plenty of investments that I sold too early. Different businesses, where being under the hedge

fund umbrella, it's a different paradigm than what I'm doing here. In that kind of institutional structure, you never want to have a down month. You never want to have a down quarter. That really puts a tight leash on you for what you are able to own.

Certainly looking back at the financial crisis and how many businesses I was involved in that have gone on to generate spectacular returns. For instance, everyone was worried about the eurozone in 2011. You could not take a risk in terms of owning some fantastic businesses like Apple, Microsoft, or even General Growth Properties. There were so many investments that went on to return 100x that you just were not able to own in the aftermath of that crisis because there was just so much fear, and you were optimizing for monthly returns.

To be clear, I am trying to generate very high returns over the long term. Of course, I care deeply about my monthly returns as well. Of course, I try not to be involved in any businesses that will blow up any specific month. But if I own a fantastic business that I think could go up 20x, 50x, or even 100x, I do not care much if it is down 10% in a month or if I underperformed the S&P by one or two percent that month. I am optimizing for the long term.

Integrating learnings

[00: 31:19] Tilman Versch: How are you taking these learnings into your process? Is there a certain feedback loop you install? How is the feedback cycle between learnings and mistakes and your process?

[00:31:33] Thatcher Martin: Sure. I will talk about my process. I think that is what you are getting to. I think about my 20 odd year investing career. The experience offers a lot of benefits, but there can be baggage there as well. If I am looking at a new business, that is, let's say, they just filed an S1, and they are about to go public. It is pretty new to me. I try to have a completely blank slate when I look at that. It is about having a beginner's mind and a growth mindset. It goes back to the idea where once you are 40, anything can be Elvis. Of course, you never want to be that person shaking your fist at Elvis.

I want to have a completely blank slate because having a blank slate and getting down to the core essence of what that business model is and what they are doing and evaluating a product-market fit, if that is a service that can satisfy a customer need. It is very easy to look at a new business and think it rhymes with something else that did not work in the past. Maybe it is a technology company that had a business model before its time, but then the next one, this new business, this one I am talking about, comes out, and it is the right time. To not let the baggage of your past skew your analytical perspective when you are looking at something new is very important.

I try to have that blank slate initially. And then, I do all the standard things. I map out the value chain. I talk to customers. I talk to competitors to try to get an understanding of the sustainability of the firm's cash flows. I assess whether those cash flows can increase over time and what the return on invested capital outlook looks like. Then, I journey map a decision tree. I think about a binomial tree where there are two outcomes, and then each node has two, and it goes over four or five iterations, and you have all these different outcomes. I am looking for, ideally, three or more things that work. These are reasons for me to own it. Three or more shots on goal where I can cut off the first few nodes, start at the fourth node and then think about how that business will unfold over time.

For me, that's helpful because it helps to map out some second and third derivatives of the trajectory of this business in terms of you have your four facets to the thesis and how those might unfold. You need to think outside the box of different potential competitive threats and other things that might impact this path of value creation. That helps me do that.

Mike Tyson says everyone has a plan until you get punched in the face. That is fine. For me, having a plan is imperative to adapt to those different scenarios ahead of time and anticipate them. Plans are useless, but planning is everything. That is how I go through those eight facets of what I look for in investments and how that translates into a process from new investment.

Eight aspects of high-quality businesses

[00:36:00] Tilman Versch: One thing that screamed at me a bit when reading through your materials is the high-quality business. Are these eight aspects the essence of the definition of a high-quality business for you?

[00:36:16] Thatcher Martin: Yes, that's right. The different facets of those eight aspects are all curated from a long-term study of high-quality businesses that have compounded over a very long period. In my experience, a lot of the genuinely transformative returns on very high-quality businesses all share a few commonalities. Obviously, they are all in different sectors in different business models, but they share a few common attributes that, in my view, are central to why they were able to create such value over such a long time. What I am looking for in my investments is investments that will follow similar paths for similar reasons because they share attributes that are not commonly understood or appreciated by other investors in the market.

Selecting 20 businesses for the portfolio

[00:37:38] Tilman Versch: Let's say you have this high-quality filter, but you only have 50 to 20 positions. How do you select between high and higher quality in the way you build your portfolio and say, "This is a high-quality business, but currently, it's not part of my portfolio."? What are the selection criteria?

[00:37:59] Thatcher Martin: Sure. I try to have 15 to 20 businesses in the portfolio. Then, I have pretty large watch lists for businesses that fit some of the attributes I am looking for, but not all of them. Sometimes that can be valuations. Sometimes that can be something else. There mau be one thing missing in their business model that precludes it from being included in the portfolio. In terms of how I think about building up the portfolio, position sizing is a function of risk-reward where the largest positions should be the ones where you can lose the least.

There are nuances to that. Sometimes a business might be particularly misunderstood in the market. The KPIs are trading well. The stocks are trading well. I don't care much about momentum, but I think that is not always appreciated because you would be crazy to have a large position in something that is completely out of tune with the market. Ideally, you can enter that position when that misunderstanding is starting to change.

At the initiation of a position, I try to have it be no more than 10%. I have three positions that are about just below 10%, seven to five percent, and then the balance is in the three to five percent range. Three at ten, seven at five, and then the remaining five to ten positions are somewhere between two to five.

That is what works best for me. It translates loosely into the 10/40 model. Sometimes you have a 10% position at initiation that significantly outperforms the rest of the portfolio. I am not looking to have one business be 20%. It is just too much risk. That is why I have a basket of these high-quality businesses because different things work at different times.

Managing risk

[00:40:52] Tilman Versch: Why not boil it down more to just maybe ten positions?

[00:40:57] Thatcher Martin: I have not had a problem finding the 15 to 20 businesses that I see a great path to value creation in. If I had ten positions that were each 10%, there is a different level of risk there. Sometimes things work for different reasons at different times. I am not trying to optimize for weekly or monthly returns. It is all about the long term. But it is still not fun to underperform in any given month. As long as I can find 15 to 20 businesses that I think are going to grow at 20% or more per year, I think it is a pretty good way to map out the portfolio.

The tool of qualitative analysis

[00:41:57] Tilman Versch: One sentence I've read on your website is, "We believe that qualitative analysis unearths the most asymmetric mispricing opportunities." How important is this qualitative analysis for you? How are you doing it? What are the factors that are important in this analysis?

[00:42:17] Thatcher Martin: The way information is disseminated to the market is rapid and in real-time. Anything related to the financials is backward-looking. Anything related to trailing valuation is backward-looking. The only way to generate outsized returns, in my view, is having a deep understanding of the business that comes through all the qualitative work.

You were asking about the things I look for in an investment. Valuation is number eight. That is always performed last because, without all that work, any kind of thinking about valuation is meaningless. After all, a PE number tells you nothing about return on invested capital, what the balance sheet looks like and such. There are so many things that are so important that the commonly used valuation numbers that people mentioned on a trailing basis are completely useless. I think 90% of the value-added in generating real outsized returns is found doing qualitative work.

Analyzing the business model

[00:44:15] Tilman Versch: How are you going about the qualitative work? What are the important methods for you to approach companies? Are you looking mostly at culture? We are happy to hear your answer on this.

[00:44:30] Thatcher Martin: The business model is the most important thing for me. It has to be a business in an industry where value creation is possible. In terms of how I assess that, it is a lot of talking to customers, competitors, understanding the customer value proposition, and paths to the future value creation of the ROIC and earnings stream in the future.

Of course, reading all the filings, reading industry magazines, finding people on LinkedIn, doing real grassroots level research to fill in any holes I might have in assessing the quality of the business. There is no simple answer. It is a long process, and it involves a lot of different touchpoints. You try to get a deep understanding of the two or three things that matter for this

business. And obviously, from those two or three things, there's a web of 20 odd things that matter for how those two or three things will unfold.

Tracking those 20 things is deeply important. In anything I invest in, I want to have two or three simple things that I can explain to a 10-year-old and not have to resort to some complicated financial model. That is a part of it, but that's never a part of the thesis. That is just helpful to iterate and understand how different factors and KPIs translate to earnings and such. I am ultimately looking for a few simple reasons for why all of my businesses are going to compound value over the long term.

How long do you analyze?

[00:46:51] Tilman Versch: How long does it usually take to build this qualitative confidence for you?

[00:46:59] Thatcher Martin: No less than two to three months for a new business. But sometimes it is much longer. I have a lot of businesses on my watch list that I have been tracking for years and years, and there have always been one or two things missing that have kept me away. The goal here is that they are always in the on-deck circle, where when something changes, I am able to tap that business into the portfolio quickly. It is a lot of work and a little bit of action when everything tees up appropriately.

The Upwork stock investment

[00:47:48] Tilman Versch: We said we want to talk about eBay and Upwork in this talk. Maybe you can explain the two to three things that matter for you in both cases also if you have some examples for these two to three things. Thanks.

[00:48:02] Thatcher Martin: Sure. That is a good example. Upwork went public in the fall of 2018. It was in a pretty weak market. I always love when new businesses come out when the markets are cratering, and you don't get some crazy pop. I had some time to study it. I studied that for about a year plus.

Upwork is an employment marketplace that connects on-demand workers on the supply side and businesses with hiring needs on the demand side. The value proposition is that it is a centralized, trusted counterparty for each side of the marketplace. On-demand workers benefit from having quality work and timely compensation, and then a reputation ranking system where they are able to use that reputation ranking to feed their customer acquisition funnel.

Businesses benefit because they are able to have access to specialized talent that enables them to hire faster, more cost-effectively, and this gives them the strategic optionality to flex a portion of their workforce based on changing demand requirements. This is a very large market. The market size is somewhere between 500 billion and 5 trillion depending on whether you are trusting McKinsey or a different. The bottom line is that Upwork has a gross services value of 4 billion. Their market share, while dominant in the industry, is tiny compared to the size of this massive market.

If you think about just the US and Europe, there are 150 million on-demand workers, but only about 5% use digital platforms to source and execute work. Upwork's business today is 80% small and medium-sized businesses that mostly use the platform for cross border IT. Upwork is building

long-term S curves in different non-IT verticals to execute a proven path to value creation that comes with spurring offline to online conversion. You can see that value creation in many other businesses that have done similar things in slightly different ways.

If you think about the barrier to on-demand work being done digitally, it is ingrained habits on the demand side. Prior to COVID, the pushback was that businesses didn't want to hire people that were not in their main offices. They thought there was some element of risk. Throughout the last ten years, you've had this great asset value creation with collaboration software and cloud computing. Then you had COVID, where everyone became a remote worker. The structural barriers are collapsing rapidly that have prevented mass adoption of a platform like Upwork.

As I said before, anytime I look for an investment I'm looking for multiple ways to win. In Upwork, I see a handful, but for this conversation, I see two main reasons why Upwork is going to help push down some of those structural barriers to adoption.

First, Upwork is modularizing the most common jobs served on the platform. They are doing this to reduce frictional barriers to adoption on the demand side. This is being executed through something called Project Catalogue. Project Catalogue is a collection of quality-verified, pre-determined, standardized projects, which businesses can purchase in an easy, clickable e-commerce type user experience. This acts as a great discovery engine that widens the customer acquisition funnel in that businesses are able to come on with this simplified, consistent customer experience and take bite-size portions to then scale across the platform and some of these other S-curves that Upwork is building.

As I have seen in so many other businesses, having a standardized, simplified, guaranteed high-quality process for a product is transformational in terms of how it changes customer habits and creates new markets. You see this in everything from McDonald's to Amazon. The process of commoditizing supply while aggregating demand breaks down barriers to adoption. As we've seen with IAC Interactive, powering offline to online conversion is a tremendous value creation mechanism. A dozen businesses have done fantastically well by commoditizing that supply and pushing forward this offline to online conversion.

Think about the labor market. There are so many unnecessary frictional inefficiencies in the labor market. There are regional talent imbalances. There is a talent shortage. Depending on where you are, businesses have a hard time finding very specific needs for what they're looking for in their workers. The structural backdrop to this is changing. I love that this helps spur forward economic mobility. If someone has a strong drive and desire to build a marketable skill for themselves, they should be able to sell that skill to a business, and they shouldn't have to live in New York or San Francisco to do that. Upwork enables that on a global scale.

Second, I like that Upwork is evolving to become an enterprise resource planning system. As a labor marketplace, there's a transactional element. It is a subscription model as well, but it's mainly viewed as a transactional business. Upwork is building an operating system for businesses to manage their workforce, both distributed and localized. They are expanding this workflow software as a service tool to help to make Upwork a platform, not solely a transactional business.

There are three parts to this. For one, Upwork is rolling out employer of record status that indemnifies businesses on the demand side from misclassification risk. That is meaningful

because it creates a position where if you are a hiring manager, you don't get fired for choosing Upwork. You're not at risk for punitive fines and back taxes. That's very meaningful for pulling the demand-side onto the platform.

Next, they are expanding the payrolling solution, which is centralized escrow protection that enables businesses to only pay for completed work. Importantly, on-demand workers get paid on time and in full. That is significant because if you ask on-demand workers, their biggest complaint is that they're not getting paid on time. A lot of businesses choose to treat on-demand workers like vendors, so they are squeezing working capital to push off payment. A centralized counterparty that protects the businesses on the demand side and on-demand workers on the supply side from any issues in payment is meaningful. Having a position in the middle of the payment flow can pull users onto the marketplace and provide that distribution relationship where they bring value to both parties.

Part of pulling the supply side onto the platform is something called Direct Contracts Offering. Now I'm seeing on-demand workers taking their work relationships they don't have through Upwork onto the Upwork platform because the simplified billing is beneficial. They are choosing to pay a take rate on that in exchange for getting paid on time and in full.

Besides those two things, Upwork is expanding analytics and reporting functionality for different productivity compliance and risk control aspects that have impacts on how it further ingrains businesses into the operating system from a solely transactional history. Having this workflow SaaS business with payroll escrow and tools for hiring managers, tax reporting, and compliance creates this flywheel where it's a category-leading two-sided marketplace. They have superior liquidity on both sides of the platform. As that grows, the gap versus competitors grows. It just builds and builds and builds. You're getting all of this at a valuation that does not give proper credit to the fact that this business can grow for 20% per year for many years. It's an 80% recurring revenue business from core clients.

In a business that is 80% small to medium-sized businesses, you get natural churn, and that's not a concern. Their recurring revenue is much stronger in enterprise clients. One of your guests spoke about cognitive reference, which is also something that I love in my businesses. Upwork has 73% direct to website traffic without search. And over time, as they build this B2B Demand generation product that's less about search engine optimization, it becomes more of a landing page where you land on the Upwork page, click to sign up, enter your credit card information, and you're done. You can build your virtual talent bench to flex your workforce based on your changing needs. This flywheel just grows and grows and grows.

In terms of valuation, I said it's undervalued based on how long I think this can continue at a 20% growth rate. Right now, it's a 73% gross margin business that is going to scale to 85. R&D, sales and marketing, G&A, they won't quite be cut in half at scale, but there's very meaningful earnings accretion for those aspects of the cost structure that are going to unfold over time. There's no reason why this can be a many bagger over time as you get this kind of zero to 10% GSV per client growth. Clients are growing at 10 to 20% a year. All that translates into 20% GSV growth, 20% revenue growth. All of this scales very attractively. I spoke about increasing returns to scale. It's very evident here. While this is not my reason for owning it, but this is also a highly strategic asset for many software vendors in the HR and small and medium business space.

Community exclusive

[1:02:17] Tilman Versch: Thank you for this great insight into your Upwork thesis. When you think about Upwork, you had to also think about Fiverr, which is a competitor in doing similar things. Why did you go for Upwork instead of Fiverr?

Hey! Tilman, here. I'm sure you're curious about the answer to this question. But this answer is exclusive to the members of my community, Good Investing Plus. Good Investing Plus is where we help each other get better as investors day by day.

If you are an ambitious, long-term-oriented investor that likes to share, please apply for Good Investing Plus. Just go to Good-Investing.net/Plus. You can also find this link in the show notes. I'm waiting for your application.

Without further ado, let's go back to the conversation.

Role of management

[1:03:13] Tilman Versch: What importance does the management play when you're investing in Upwork and other companies? Is it in your focus of the research? How do you value management?

[1:03:26] Thatcher Martin: It's definitely very important. Everyone says the same thing about management. You want a high-quality management team with character and integrity that has a history of creating value with other businesses. They have a history of doing the processes to create value in this business. Of course, all of those things are very important to me.

I also factor in the opportunity of the business and the pathway for value creation. That's very important too. I would never invest in a business with questionable management with questionable ethics and character. That's just a non-starter for me. The management of Upwork, Hayden Brown comes from a product background. She's very capable, a very strong manager. I like to have owner-operators or entrepreneurs. While she is not the entrepreneur, I really like the product background that she came from. I think she's doing great things with this business and will continue to do so going forward.

Dealing with competitive businesses in an industry

[1:04:47] Tilman Versch: Zooming out to your portfolio, would it be okay for you out of the diversification thinking to own two investments in the space? So, it's like you say, Fiverr gets cheaper, and you say, "Oh, Fiverr also looks interesting. How about I own them both?" Or is it that you say, "I focus on certain industries and want to pick one winner."?

[1:05:10] Thatcher Martin: I do not own Fiverr as well. The way I think about it is, I want each of my businesses to have a growing end market that is uncorrelated with the rest of the portfolio. It doesn't mean I can't own several businesses that are in the technology or communication sector, but I want the actual end market and factors in the end market driving growth of the end market to be uncorrelated with other businesses in the portfolio.

Obviously, I've seen in the last two, three years, you have some of these factor-beta unwinds, where you get a rate backup, and anything remotely related to communications or tech gets hammered. I'm concerned about the actual path of the business. I'm willing to wear a little P&L

as the machines move stuff around, even though it's not related to the business. It's the correlation of that end market, which matters for value creation. And that is what enables me to have the stomach and intestinal fortitude to hold these fantastic businesses. If you're smart or lucky enough to find a 5-10-100 bagger, it is really important to have that discipline. Everyone wants to know about your sell discipline but hold discipline for a fantastic business is also extremely important. You get that by understanding the key drivers of the business and the key drivers of the end market. Having a portfolio of businesses with uncorrelated end markets is very helpful. Like, yesterday, the 10 year treasury going up ten basis points is going to cause some stocks to get hit. But that's a short-term issue. The businesses I'm owning are not levered. Rates are not a factor for the trajectory of the business. Transitory spikes sometimes pressure them, but the path to value creation in the actual business is completely unaffected. That's important for owning these names and compounding portfolio returns at a high clip.

Deep understanding is key

[1:08:12] Tilman Versch: So, the key to your whole discipline is just deep understanding. Or do you have any other keys to the whole discipline?

[1:08:20] Thatcher Martin: A deep understanding of the business and the path of value creation creates the impetus for really attractive opportunities when you get some of this factor-beta unwinds where certain names could sell off for 10% in a month for no real reason besides what different names in the sector are doing.

There's just so much money in the market now in these very large quant strategies that create really attractive opportunities for long-term businesses several times a year. You just have to have that deep understanding and do the work ahead of time. Every once in a while, you get really attractive opportunities. That was the case for Upwork for me. It was a pretty quick double from when I bought it. It has come down a little bit in the last couple of months. They issued a convert, and that's part of it. There are so many fantastic businesses unduly pressured by factor-beta trends that you just have to prepare and be ready for because opportunity favors the prepared mind.

Selling

[1:09:54] Tilman Versch: So, what is your reason to sell then? Is it that your holdings don't execute against the two or three things you consider important? What drives you to sell a position then?

[1:10:06] Thatcher Martin: I sell when the thesis breaks. I have my reasons for owning it. I have my journey mapped binomial tree of different scenarios. If the path to value creation is taking an alternate route, whether a change in management, changes in the competitive environment, anything that impacts what the business is going to look like over my expected holding period, that would cause me to sell.

I think a lot of people say they never sell based on valuation. I don't know if I'd go that far because sometimes things get particularly skewed in terms of their valuation. But that tends to not be a reason for me to sell. Depending on the situation, of course. It is always about the thesis breaking because there are 15 to 20 names in the portfolio, which forces me to rank the path to value creation in the various businesses. Adding a new 5% position in the portfolio typically means something else has to get kicked out. If the expected return in something new is significantly

better than something I've had for a while that has had that thesis break in some way, then it's a pretty easy decision. My holding period tends to be pretty long, two-plus years at a minimum.

It's a very tax-efficient strategy. Related to that, if the thesis breaks and there is negative P&L on, I always try to realize those types of losses.

Example of eBay stock

[1:12:14] Tilman Versch: You have one position in your portfolio that I also want to discuss. It's eBay. eBay fascinated me a bit because if you go for the write-ups you posted, it's Catalytic, Pinterest, wix.com, Match, Roku, all these kinds of fancy businesses. And then, there's one we have in a while. That's the good old eBay? How does it fit in the thinking about your portfolio? How does it relate to thinking about the correlation with other positions? What is the idea behind eBay?

[1:12:48] Thatcher Martin: Sure. I took a position in eBay in early January of 2019 for around 30 bucks. The consensus at the time was that Amazon was disrupting eBay. There was just this intense focus on the gross merchandising volume of the business. I actually thought that eBay was a fantastic business embarking on a few self-help initiatives that could grow sales and margins.

The core marketplace business at eBay is asset light. It prints free cash flow. It's just a fantastic business despite the consensus at the time that Amazon was disrupting it. There were three parts to my thesis. One was that eBay was moving payment processing from PayPal after the termination of that contract in 2020.

Shifting that payment processing from PayPal positioned eBay to earn the spread on gross merchandising volume of 100 billion. So, PayPal took about 4%. I thought that even if eBay only took three and a half percent, the marketplace revenues were like 8.6 billion at the time. So, you know, three and a half billion on 8.6 of high margin revenue coming in the door is meaningful. It would also lower the take rate and improve the value proposition for sellers in the eBay ecosystem.

Second, I thought that eBay was in the early stages of allowing promoted listings on the marketplace. In similar businesses, promoted listings generate somewhere between two to 3 three percent in advertising revenue, two to three percent of the GMV. There's an argument that it could be much higher but just based on other businesses, call it two or three percent. That's another two to three billion of high margin revenue coming in the door as they started to embark on this low-hanging fruit, no brainer path to value creation.

Third, I thought there was substantial hidden asset value within eBay. eBay had StubHub and International Classifieds. They were both operated autonomously. They were high-margin businesses that grew at a double-digit rate. Additionally, they had warrants for a five percent stake in Adyen, which is a fantastic business as well. That was as part of an agreement they made once the agreement with PayPal was expiring in 2020.

Because of those hidden asset values in StubHub, Classifieds and then later Adyen, I was buying the core marketplace business of eBay, depending on what my assumptions were for those three assets that I mentioned, somewhere between three to five times EBITDA for the eBay

marketplace. I am not talking about some super levered TIO2 cyclical business. I'm talking about a fantastic high free cash flow business in eBay that in no world should that trade at three times EBITDA.

I should say that I'm not a believer in sum of the parts valuation methods. They tend to be value trap valuation methodologies. But it was clear to me that the management of eBay was very open to monetizing these assets. I had a high enough confidence level in the first two parts of my thesis where even if I was wrong about the willingness of management to monetize these assets, I thought I could still generate my 20% IRR bogey for this business. I had three shots on goal. I felt very good about really all three of them, but all of them didn't need to work.

That was my thought process in 2019. eBay had a market cap of 27 billion, an enterprise value of 32 billion, and they had about 950 million shares. Since then, they have sold StubHub for four billion and used those proceeds to repurchase shares. They sold the classified business to Adevinta for nine billion, two and a half billion of which was cash, the rest of which was in shares. As part of the shares that they received, those went on to skyrocket. So, that nine billion was really more than 13 billion.

More recently, they sold an 80% stake in the Korean business for three billion. That wasn't part of my initial thesis, but it helped. All told you talking about 20 billion in assets sales on a market cap at my purchase price of 27 billion. So, fast forward to today, the market cap is 48 billion, enterprise value is 40 billion. They have repurchased about 30% of the shares. They have done a couple of other things in terms of implementing a guaranteed program for helping ease some frictional barriers to adoption and product verticals like expensive handbags, watches, and so on. They are doing a tech led reimagination of search engine optimization and price matching of the business.

One great thing about the scale of eBay is there are so many niche collectible businesses that transact on this platform. They can design this authenticity guarantee program in watches and then roll it out to dozens of other similar verticals that there's no incremental cost or minimal incremental costs to doing that. And they have the scale where all these repeat customers are rediscovering this platform. It's just a fantastic business.

Now, I was right about the three parts of my thesis, but this stock kind of did nothing in 2019. Same in 2020. They've done well this year, but it was a drag on performance for the portfolio most of the time I've held it. So, it was one of my least successful investments, but it had a valuable role in that it lowered the portfolio's duration a bit, which some of the value of the catalyst names tends to do. That helps create balance to the portfolio anytime you get those factor-beta spikes that I mentioned before. In addition to having a 20%-ish IRR, it also had an attractive risk mitigation role in the portfolio.

Looking forward, they're about halfway through the first two parts of my thesis and complete on the last part of my thesis. I'd say for me, the low-hanging fruit in this path to value creation has been picked. But I still think it's a fantastic business that can grow over time with some of these initiatives. They are share cannibal, and now they have a dividend that wasn't there before. It is still a pretty high-quality business.

[1:21:53] Tilman Versch: How does it fit your eight key criteria for high-quality businesses? Because I think I haven't written down all the details of these definitions, but they assume a

certain way of growing end markets, this long runway of free investment opportunities, and the competitive advantage that's growing. So, how does eBay fit in this framework?

[1:22:22] Thatcher Martin: There is repeatability in the business model. The path to value creation was very predictable. There were those three simple things that were happening and ultimately did. Growing end markets, e-commerce is growing so that it checks that box. Increasing returns to scale was true for how they're implementing some of these authenticity guarantees and other initiatives across their product set and portfolio.

The way I mentioned that increasing returns to scale in Upwork is a little different because there's a major margin inflection as the scalable demand growth layers on top of that low fixed cost structure. Increasing returns to scale are evident at eBay, just in a slightly different manner than what I talked about in Upwork. A long runway of high ROIC opportunities was very prevalent at eBay. The catalyst was the asset monetization

[1:23:39] Tilman Versch: Are there buybacks also for these ROIC opportunities, or is it building the business?

[1:23:47] Thatcher Martin: It tends to be more building the business. In a business that's a little more mature like eBay, buying back a lot of shares is a good path to creating a lot of value, but in other businesses and portfolios, I prefer to see organic areas to grow, where they're able to use that internally generated free cash flow to reinvest in different ROIC opportunities. eBay does have a fair number of ROIC opportunities that they can use their free cash flow on. The growth of the end market here is just not as significant as some of the other businesses in the portfolio.

The catalyst was very clearly there. A competitive advantage that must be growing. In my view, eBay is a fantastic business that maybe could have been managed a little bit better. Some of the things that the current management team is doing are working to grow that competitive advantage so that it checks that box. Valuation; I was buying the core marketplace business at three times EBITDA, which is even less after some of these initiatives are done.

[1:25:28] Tilman Versch: Thank you very much for these great insights --your process and the way you approach investing and two stocks. For the end of our interview, do you have a pointer that we haven't discussed? It could also be two points. Do you want to mention anything interesting for us?

[1:25:46] Thatcher Martin: Nothing jumps up. You are a good interviewer.

US markets vs. global markets

[1:25:52] Tilman Versch: For the end of our interview, I'm going to ask one last question about the composition of your portfolio. It has a certain tendency to be focused on American businesses. Is that the market you're mostly looking at? Or how do you find yourself as a global investor finding the best opportunities in the US markets?

[1:26:17] Thatcher Martin: It is what I know best. Usually, there's a pretty high bar for me to invest in something overseas. I have to know the business and understand the path to value creation very well in the same way I do for anything in the portfolio. That's harder sometimes when I'm not there. In certain countries, an American investor can be the last to know. I will say that some of

the businesses I am investing in have a global scale in terms of their business model. Something like STNE that's very clearly Brazil, and, you know, other parts of Latin America probably in the future, but it's very much a Brazilian investment. Something like WIX is a global investment listed in the US, based in Israel. That's a US business, but it's a global business.

Upwork is very much a global business as well. It just has to be something that I'm not going to be among the later people to know about. That tends to happen in a lot of EM markets. I'm not looking to be a tourist somewhere. I'm looking to have some kind of deep edge that comes from my analytical ability to understand the business and understand the path to value creation.

[1:28:21] Tilman Versch:
Thank you very much for the great insights and the time you spent with me doing this interview.

[1:28:27] Thatcher Martin: Thank you, Tilman.

[1:28:29] Tilman Versch: Thank you for listening to the audience. See you soon in the next episode. Bye!

[1:28:35] Thatcher Martin: Bye.

Disclaimer

[1:28:36] Tilman Versch: Here is the Disclaimer. You can find the link to the Disclaimer below in the show notes. The Disclaimer says, always do your work. What we're doing here are no recommendation and no advice. So, please always do your own work. Thank you very much.