July 14, 2020

"To expect the unexpected shows a thoroughly modern intellect"

- Oscar Wilde

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

- Usually, and ironically, misattributed to Mark Twain

Dear Partner,

The estimated second quarter of 2020 and historical net performance for North Peak Capital Partners, LP ("the Fund") are presented below. During the quarter, the Fund averaged 65% net long exposure and 164% gross exposure. Performance was positively impacted by SE, HUBS, and SPLK[1] and negatively impacted by our short book broadly, and especially by our index shorts and ONEM.

Performance Summary:

	North Peak	Russell 2000	Difference
Quarter	22.9%	25.4%	(2.5)%
Year to Date	1.1%	(13.0)%	14.1%
Since Inception	188.2%	24.7%	163.5%

Returns presented above are net of 1.5% management fee and 17% incentive allocation since inception (August 2015). Each Limited Partner's actual performance will vary depending on the timing of their contribution(s), the fund selection, and fees. Please see additional disclosure.

We begin by commenting on a statement from our April letter:

"Until the heightened uncertainty subsides, we will run with lower net and lower gross, which will lead to underperformance in strong markets, but guarantees preservation of capital through a volatile moment. Here we are deliberately invoking intellectual humility."

As we suggested that we might, we did in fact run the portfolio with lower than typical net exposure in the quarter, particularly in the early parts of the quarter, when the market was *en fuego*. However, what felt like prudent conservatism at the time of the last letter looks wrong in the rearview mirror,

[1] As well as by an undisclosed foreign security.

when the Russell 2000 appreciated 22% in the month of April, the market's best month since the Great Depression. Did we not heed Baron Rothchild's famous adage to "buy when there is blood in the streets," or Buffett's notion that one should "be greedy when others are fearful, and fearful when others are greedy?" As it turns out, contrarianism is hard, even for investors who wake up every day excited by the intellectual and emotional challenge that it presents.

Candidly, we would submit that we did not play the market's latest rebound particularly well. In hindsight, we wish we were bolder, that we had been more aggressive in the midst of the panic. And because we were not, we underperformed the index exactly as we suggested that we might in April. Index shorting alone adversely impacted returns by over 10% (i.e. 1,000bps) in the quarter, and the total short book in general was a ~16% drag on performance.

Luckily, our positioning error this quarter was countered by an array of companies in our long book that collectively posted an extraordinary quarter through the earnings season, showing their quality and durability during an outright crisis. The strength in the long book (+38% in the quarter) essentially allowed the Fund's portfolio to nearly match, on a net basis, the best quarter for the Russell 2000 in fifty years despite the meaningful positioning drag discussed in the prior paragraph.

All told, then, we are reasonably happy with the quarter, and happier still that the world is one quarter closer to a solution to a huge global problem. Of course, we are highly cognizant of two other facts: first, investment performance should not be measured in quarters; and second, the history of the pandemic has yet to be written. We will reserve victory laps for a later date.

So much has been written on the disconnect between the real economy and the stock market performance. We too have pondered the question, and dichotomy, at some length, and frankly remain somewhat puzzled, like so many other market participants. That said, we are reasonably sure that the answer lies in the following confluence of factors:

(i) a demonstrated willingness, and even determination, on the part of policy makers to help businesses, and indirectly, their employees;
(ii) historically low interest rates (and arguably, historically low equity risk premium);
(iii) seemingly incredible progress on the part of the scientific community towards the likelihood and near-term timing of a vaccine, as well as a few notable therapeutic advances;
(iv) the general observation that we wrote about in our Q4 2018 letter that the prospect of a recession should not have too material an effect on the valuation of companies; this idea has recently been promulgated more broadly, including prominently by Bill Gates.

Please note that only the last of these factors is immutably true. As business owners and shareholders, we can hope, and even expect, the others to remain true or progress favorably, but they are not laws of nature, nor are they mathematical truisms. Given that multi-dimension**al** uncertainty, you might ask, will this disconnect persist, and will the stock market remain relatively healthy while real economy wrestles with a severe recession? We don't know.

Some among you probably find that answer disturbing. After all, you have entrusted us with your capital to invest in equities. And for sure, when you read these letters, you want to believe, and hopefully reinforce the view, that we are smart, intelligent investors with a perspective on matters of such relevance. And yet, we do not know.

In fact, 'not knowing' is a core tenet of our investment process. The art and science of valuation at the heart of our investment process is predicated on predicting the future. As it turns out, everything in the future lies on a continuum of predictability, and nothing is certain. Will the sun rise tomorrow? Absolutely. Who will win the US presidential election? That one is a bit more difficult to call, though we can speculate that most of you have a strong opinion on the matter. Who will win the presidential election in 2028? That one seems foolish to discuss at this juncture.

We believe that investing requires the same sort of judgments about what is knowable and what is fundamentally unknowable – and specifically knowable to us. As stewards of your capital and ours, we seek asymmetric odds in uncertain situations, where the risk-reward is skewed in our collective favor. That is, we look for investments where predictability, after considerable study, seems reasonable: we seek clarity, not certainty. Will the local little league team beat a major league team? Not certain, but clearly alluring to place an even-odds wager on the big-leagues sluggers. The clarity we seek is usually based on our understanding of human behavior and extrapolations of past patterns. We believe that those extrapolations are more reliable when the drivers are well understood. For instance, if a cookie jar has 100 cookies, and one were to remove four cookies per day, the pattern would look like this 4, 4, 4, 4, 4, 4, 4, 4, ….. If one were to observe that pattern, and "guess" the number of cookies that would be removed on any subsequent day, the best guess would be "4"; except that on the 26th day, there would be no more cookies left. That is, it is crucial to try to understand the drivers of a pattern to determine *how* to extrapolate it. If one understands that there are only 100 cookies in the jar, determining the number of cookies drawn on the 26th day is simple; by contrast, blind extrapolation, without regard for the underlying structure, leads to an incorrect prediction.

In practice, the type of drivers that we rely on employ intuitive propositions such as:

- Happy customers come back
- People act in line with their financial incentives
- Businesses seek solutions that enhance their profitability
- Managers who buy their own stock think it will appreciate
- Given two equal products, people tend to stick with the one they know

We spend the bulk of our research process on the application of these common-sense principles. Are the customers happy? Is the product better than alternatives? How much better?

As we have said before, and will always repeat when asked, we have assembled a portfolio of investments which we believe will be successful and durable in the face of great uncertainty. Relative to the number of investments we have made, we have evaluated and passed on multiples more, where we just don't know. That pantheon of equities that are "too hard" or "unknowable" comprises a large portion of what people refer to as 'the stock market.' It follows, therefore, that we really cannot predict the market, given that we have actively determined that its constituent parts are themselves inscrutable.

Before discussing a few new investments, we close these remarks with another comment from our April letter.

"… we believe the world will certainly emerge from the pandemic, but probably forever changed, hopefully in some ways better prepared to meet humanity's next challenge. Never bet against human ingenuity!"

Upon further reflection, this last point guides so much of our thinking. We have had the opportunity to back so many great entrepreneurs and business leaders, changing the world for the better. We will continue to invest in extraordinary people doing extraordinary things, qualified by the most important principle: only when we see value!

Zendesk

In June, we initiated a position in Zendesk, a leading provider of customer service software. Zendesk's SaaS solutions enable organizations of all sizes, in every industry, to deliver transparent, responsive, and exceptional customer service via an easy-to-use customer service management platform. Since its 2014 IPO, Zendesk has grown robustly and delivered operating leverage (North Peak's favorite combination). Specifically, from 2015 to 2019, Zendesk grew customers and revenue at a CAGR of 23% and 40%, respectively, while expanding adjusted operating margins from (24)% to +5%.

We expect Zendesk both to continue to grow quickly and to expand its operating margins over the coming years as it adds revenue (cross-selling) from the existing customer base and reduces churn from within it. While Zendesk was founded as an easy-to-use solution for small and medium-sized businesses, it has increasingly broadened its focus to sell to larger enterprises (which churn less frequently), with great success. Revenue from these larger companies increased from 24% of ARR in 2014 to 43% in 2019, more than tenfold in absolute dollars! Moreover, Zendesk has broadened its product suite beyond its core customer service application, now offering additional products to provide chat, voice, and self-service automation within customer service. The Company's open platform also enables customers to build custom solutions on its core application. Zendesk's R&D innovation has created new products that have underpinned its historical growth: as of 2019, 29% of Zendesk's customers purchased multiple products, up from just 9% three years earlier, a trend that we expect to continue. Moreover, multi-product adoption helps increase customer stickiness – the more products a customer uses, the more embedded Zendesk becomes. Finally, we believe that the market has unfairly penalized Zendesk in the current pandemic-related environment. Zendesk has underperformed SaaS by more than 40% year-to-date, primarily on worries that its majority-SMB customer base would be disproportionately impacted by COVID-related challenges. While potentially damaging in the short-run, COVID will likely benefit Zendesk over the medium- to long-term, because COVID accelerates transitions to remote and online settings for customer support, particularly in markets like e-commerce.

Over the next five years, we expect Zendesk to grow revenue 25% annually and adjusted EBITDA from ~$80 million in 2020 to ~$900 million in 2025. Assuming the business trades at 8.0x sales multiple or a 3.5% free cash flow yield, we expect shares to appreciate from $80 per share to $225 per share, generating a 20%+ IRR. In addition, while M&A is never core to our underwriting thesis, we note that Zendesk would be a highly-attractive asset for larger SaaS companies like Adobe, Shopify or SAP, and could be acquired at an attractive multiple, thus compressing our return timeline.

Spotify

Music is one of the most universal elements of our common humanity and may well be one of the largest global markets in terms of users. There is significant evidence that music is hardwired into our brains. In the United States, the average adult listens to 32 hours of music per week, nearly as much as video (37 hours per week), and well more than social media (9 hours per week). Despite its prevalence, most music listening today is either un-monetized each year (due to piracy or previously-purchased physical media), or under-monetized (via terrestrial radio or YouTube) to its creators and distributors. As a result, music under-earns its usage: global radio and recorded music industry revenues are ~$60 billion, far below video (more than $350 billion) and even social media.

During the quarter, we initiated an investment in Spotify, which pioneered and remains the leader in online music streaming. Over the last several years, the music streaming industry has developed in response to the rampant piracy and the general under-monetization of music. Music streaming competitors, and Spotify itself, offer consumers full, on-demand access to nearly all recorded music ever created – more than 30 million total songs. Users can either listen for free (with ads and some feature restrictions) or can opt into a premium service for $5 - $10 per month (in Western markets) for unlimited access. In other words, Spotify created a product that is superior to today's under-monetized listening options, offering better selection and a superior user experience.

Resonating globally, the Company has grown total users 40% annually (~8x) since 2013 and paying users 60% annually (~16x) over the same timeframe. Globally Spotify now boasts 286 million monthly active users and 130 million paying users across six continents. Despite the Company's success, we believe there is significant runway ahead. Total paid streaming is approximately 20% penetrated in the US and less than 10% penetrated in Europe, LATAM, and Asia. By comparison, in Sweden and Norway, Spotify's original 2008 launch markets, more than half the population pays for streaming – and that penetration is still growing!

Moreover, while Spotify currently prioritizes user growth, we believe the business has substantial untapped pricing power over the long-term, as it has held pricing flat in most markets since inception, unlike entertainment peers like Netflix who have begun to successfully raise prices to great effect. Spotify recently began testing its pricing power, raising prices in the Nordics (its most mature markets) by 10-13%. Encouragingly, it has not suffered adverse impacts on churn or conversion and has, in fact, seen user growth in the Nordics re-accelerate since late 2019. In addition, Spotify has been aggressively investing into podcasting and advertiser tools, two areas that should provide further opportunities to leverage its highly-engaged user base and drive long-term monetization.

Concerns about Spotify's future generally take two forms: its competitive position and its economic relationship to the record labels. While Spotify remains by far the market leader, Apple, Amazon, and Google have each launched competing music services with similar catalogs. Despite this, Spotify has been able to continue to distinguish itself across several vectors. First, the Company has invested heavily into AI and machine learning efforts to facilitate data-driven personalization. Because no human being can sift through 30 million songs, differentiated personalization can drive song discovery which can, in turn, create the *impression* of a larger and better music catalog. Moreover, this advantage grows over time: the longer a user remains a Spotify subscriber, the better the algorithm becomes at recommending songs, the better the user experience, and thus the stickier that subscriber becomes. Indeed, credit card data which we purchase on Spotify bears

this out: in the US, around 20% of subscribers churn off the platform in their first year, but that churn drops in subsequent years, below 5% annually for subscribers who have been paying for at least five years. This low level of churn reflects a beloved product, and approaches best-in-class levels set by Netflix which has highly differentiated content. That is, through personalization and a series of other differentiators (UI/UX, playlist history), users behave incredibly loyally.

Spotify also maintains a top of the funnel customer acquisition advantage over its competitors through its free offering. To date, Spotify is the only player to have negotiated rights with the record labels to offer a free service with an equivalently broad song catalog. Spotify initially lures users with free streaming, then, as they become more embedded in the platform over time, the Company gradually converts them to paying subscribers.

Lastly, Spotify has recently moved aggressively into proprietary podcasts - embedding a podcast player into its core app and acquiring several leading podcast studios. In podcasts, Spotify, like Netflix, *can* offer exclusive content that it bundles with music, further deepening its differentiation versus the competition. Together, in our judgment, these advantages translate to a defensible long-term moat.

The data supports the hypothesis that Spotify is winning: its user growth improved over the last 12 months, re-accelerating from 25% in Q1 19 to 32% in Q1 20, even as the broader music industry continues to decelerate. Because much of the future user growth will come internationally, we expect Spotify's market share to grow, since its two largest competitors (Apple and Amazon) have relatively weaker ecosystems overseas.

As importantly, we believe the Company's advantages are durable: Spotify has ~5x the listening hours of AAPL (the #2 player), giving it a structural edge in personalization. It also has exclusive rights and ownership to many top podcast content studios. Even if others wanted to try to compete in podcasts, it is likely too late to build a comparable content slate anytime soon. Finally, in the technology industry, history teaches that focus often wins: Tinder prevailed over Facebook Dating, Zoom prevailed over Google Hangouts, and Shopee is seemingly prevailing over Alibaba in Southeast Asian e-commerce. Usually, the niche player whose very existence depends on excellence in its niche prevails over tech giants for whom the niche is merely a side business. We believe that the odds are similarly stacked in Spotify's favor in the music streaming business.

The second key concern relates to Spotify's relationship with the record labels. The three major record labels (Universal, Sony, and Warner) control approximately 70% of music in Western markets. Moreover, unlike in video, a successful music service requires a nearly "complete" catalog, meaning Spotify needs licenses from all three major labels in order to have a viable long-term product. Consequently, roughly 65% of Spotify's revenues today go to the record labels as royalty payments. For our investment case, the status quo is fine – the market is large enough that Spotify can make plenty of money even at current royalty splits. We have invested significant research effort speaking with music industry executives to understand how the splits might evolve over time. To our surprise, most record industry watchers were confident that Spotify would maintain and indeed increase their share of the pie. Essentially, they noted that the labels need Spotify as much as Spotify needs them. If, for example, recently-IPO'd Warner Music Group lost its contract with Spotify, ~100% of its EBIT would vanish overnight. It would be a risky gambit for all parties. So long as Spotify continues growing the overall pie, we believe that it will maintain its economic leverage.

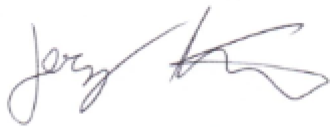
Ultimately, we are quite optimistic that Spotify can continue growing users and, over the longer-term, ARPU, resulting in sustainable 20%+ revenue growth accompanied by operating leverage as the business continues to scale globally into a large market opportunity. If we are right, that will result in Spotify generating more than €24 billion of revenues and €4 billion of EBIT by 2025. At a 20x EBIT multiple this results in a ~$700 share price in five years - and substantially more if current investments into podcasts and advertising pay off. We initially purchased shares at approximately $185 and watched the stock subsequently rise to nearly $260 as of quarter-end. We continue to like the business prospects (and the investment itself) over the long-term but have reduced the position and have locked-in some of the initial gains, in light of the higher current share price.

Conclusion

During the quarter, we welcomed two new large endowments that we discussed as prospects in our fourth quarter letter. As we have grown AUM, we continue to invest in our research, so that we can continue to earn strong returns on capital. To that end, we have hired another research analyst, who will be joining us from Point 72 once his non-compete expires in October, bringing the investment team to four. We also continue to invest in additional alternative data resources to inform our investment theses.

North Peak Special Opportunity Partners, LLC is still open for subscription, and we recently set up North Peak Special Opportunity Partners II, LLC which we will send you an invite to learn about shortly.

We remain optimistic about our portfolio and confident in the deep research on which it is predicated. We will always stay disciplined in choosing opportunities with your precious capital. Thank you again for the opportunity to manage it.



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