To: Highway One Asset Management Partners
From: Stefan Culibrk
Subject: Annual letter 2021
Date: January 26th, 2022

Dear Partner,

Our return in 2021 was -0.1%[1]. Contributions to our returns are available on page 9.

	Return	S&P 500
2021	-0.1%	+28.7%
Since inception (Jan 2020)	+46.5%	+52.4%

During the first quarter of 2022, Highway One will move from a managed account structure into Highway One Fund. In the first days of the fund, I will do what I have always done – invest in a handful of businesses I have known for years at bargain prices.

These businesses are at different stages of their journeys. Some are cash generative and have a long operating history. Charter Communications, one of our significant investments, is the second-largest cable operator in the United States. Unit economics per subscriber tell the same story as their financial statements. Despite tripling over the past five years, the company remains undervalued because the market is concerned about the sustainability of its earnings given the perceived change in the competitive landscape.

Other businesses are relatively new and unprofitable. Opendoor, our most recent investment, described in detail on pages 2 to 5, is still in its economic infancy. It is offering a fraction of its product portfolio to a sliver of the market that could benefit from using it. Its growth investments overwhelm the attractive unit economics. The shares are undervalued because the market is questioning whether they can make money at all.

There are significant differences among unprofitable companies. Companies such as Uber are unprofitable by choice and able to survive a dire recession without relying on the kindness of strangers due to their cash reserve. On the other hand, companies like Peloton are unprofitable while building a layer of fixed cost to support an increase in volumes. If growth falters while management keeps spending, the company becomes fragile and dependent on external funding.

[1] The return figure is a statistic called time-weighted composite. This is industry-speak for the rate of return that best describes the return for all partners, but none in particular. It is net of fees.

While fragility is alive and well in mature businesses (how many hundred-year-old businesses are still around?), young companies are especially brittle and susceptible to external and internal influences. The volatility of their results is only surpassed by the fluctuation of their stock price.

The value of an unprofitable company comes from its future profits. Over the short term, its price is set like that of a Picasso—worth whatever someone is willing to pay. Unit economics start showing up in the financial statements as a business matures. If the company pleases customers while exhibiting attractive economics at scale, shareholders start swimming in cash.

It is tempting to take business maturity as a philosophers' stone. The desired end state of one business might be an opening for a competitor—even the mighty are virtually guaranteed to fall if given enough time. I try to find the rare companies that delay old age by repeatedly finding a way to provide value to their customers.

During the past four months, the rise in interest rates reduced investor patience towards unprofitable companies, leading to a steep decline in the prices of our portfolio companies. We did not invest in Uber and Angi because of a narrative, nor do we plan to sell because of its change. Moreover, we did not invest hoping that interest rates would remain at zero forever. Instead, we invested for the future cash flows, appropriately discounted to the present.

Investing treads a fine line between exercising patience when the business encounters inevitable bumps and selling when the crux of the thesis crumbles. Investors tend to abuse the liquidity of the public markets and liquidate their holdings as soon as the business slows down or the unrealized losses reach an uncomfortable level. The inability to hold during turbulence is one of the reasons why only a handful of investors compounded at rates approaching those of the best-performing companies.

<u>New investment – Opendoor</u>

Every year more than six million homes in the United States change ownership. Although Americans relocate a lot compared to other nations, buying and selling a house is still a stressful experience. The seller needs to show the property to dozens of potential buyers. Most buyers rely on a mortgage, introducing closing risk to the seller. Sellers frequently move out of their homes into temporary accommodation to have enough time to look for a new home while avoiding a double mortgage.

There is a lot of money at stake. For an average American, home equity is more than a quarter of their net worth. The seller typically pays a 6% commission, split between the buyer's and seller's agents. Agents collected more than $100bn in 2021. Nine out of ten transactions include an agent despite misaligned incentives: agents optimize for transaction volume, sellers for price.

What does Opendoor do?

In 2014 Opendoor set out to disrupt residential real estate transactions by offering a near-instant bid to the seller. The process starts when a seller submits information about the property to Opendoor. After a virtual inspection by Opendoor's staff, the company offers a firm price at which it is ready to acquire the home. The seller has avoided months of showings and haggling over the price. Opendoor charges a 5% commission to the seller. Opendoor also offers to buy the seller's next home in cash before the close, allowing the seller to lock in both sides of the transaction. The seller can manage the transition as they please, avoiding double mortgages and moving into temporary accommodations.

For the business model to have integrity, Opendoor needs to bid for a vast majority of inquiries. The business is resonating with the sellers. Five out of ten sellers that asked for a quote with a firm selling intent ended up transacting with Opendoor.

Three things immediately come to mind:

1) the business is highly capital intensive;
2) there is little room for error;
3) successful execution marries the digital and physical world.

Eric Wu and his co-founders started building the business taking this into account.

Is the business viable?

Opendoor charges a 5% commission and bids on the house at a discount to their assessment of the fair value, corresponding to the property risk. If a house is in a homogenous neighborhood like Phoenix, Arizona, Opendoor will bid a few percentage points away from their estimate of fair market value. If a house is old, idiosyncratic, and has uncertain liquidity, the spread would widen.

Opendoor makes money from the commission, house price appreciation, and ancillary services such as the seller's title and escrow insurance. Then, after minor renovations, the company puts the house back on the market.

During the 90 days it typically holds the house, Opendoor pays its utilities, taxes, and interest on the debt that financed the purchase. Most buyers of its inventory are individuals with agents, leading to the additional expense for Opendoor - buyer's agent commission.

As Opendoor captures an increasing number of sellers, they can also catch a growing number of buyers—more than two-thirds of sellers are buyers. Working with buyers will enable the company to offer lucrative, high-margin, no-risk products such as a mortgage, home insurance, home warranty, and upgrades.

Opendoor bought 15,181 houses in the past quarter, sold 5,988, and made $24,005 in gross profit per house sold,[2] a 6.3% margin. The surging housing market aided this feat—the normalized margin is closer to 4%. With inventory turnaround four times per year, the business makes a mouth-watering 16% return on assets. While the business would struggle at double-digit interest rates, it could easily digest a return to more normal levels.

Competition

The traditional real estate transaction is the biggest competitor, followed by Offerpad, a pure-play instant buyer; Redfin, a real estate brokerage; and Zillow, a well-regarded real estate marketplace, who have tried to replicate Opendoor's business model.

In November 2021, Zillow announced that it expects to suffer significant losses from its portfolio of homes and plans to cease the business segment to focus on its lucrative agent lead generation business. Understanding what went wrong with Zillow in a relatively benign housing market is vital for Opendoor investors.

Zillow's instant buying business targeted narrow margins of +2% to -2%, aiming to offer a fair price to the sellers. In early 2021, it could not keep up with Opendoor's market share growth. Months after Zillow bid too little, it started bidding too much. Zillow accelerated purchases by paying top dollar for homes during September and October, relying on overly aggressive assumptions for future house price appreciation. As a result, Zillow lost 8% per home on a large cohort of homes acquired in September and October. Such significant variance versus expected returns rightly scared the company's leadership into thinking that its house buying operation could lose so much money in a poor economic environment that it would drown the lead generation business. Compared to Opendoor and Offerpad, Zillow was never all in – its core competencies centered around user acquisition and agent satisfaction, leading to high margins typical of a dominant marketplace in a vertical. It struggled with the boots-on-the-ground operations of a leveraged, low-margin enterprise.

With Zillow out of the competition, Redfin operating a more niche strategy, and Offerpad growing slower, given a more manual approach, Opendoor has a shot at conquering the market.

[2] Opendoor's reported contribution margin minus mezzanine interest.

Risks and can it survive a downturn?

Over the past fifty years, the most significant quarterly decline in house prices was 3%. During the Great Recession, transaction volume declined 50%, and the time needed to sell the home increased. Opendoor might have lower margins during a crisis due to declining house prices. The cost of funding could increase while its availability decreases. However, the situation would need to be multiple times worse than the Great Recession to cause permanent damage.

Apart from the apparent risks, Opendoor currently does not report per vintage profitability or breakdown of its inventory. The company could mask a dire state of its inventory while it is growing rapidly. However, I do not have reason to believe this is the case. The company executed a near-total winddown of its portfolio last year and suffered no losses.

Valuation

Opendoor recognizes revenue when it sells a home. Gross profit from transactions matched the cash expenses of the business in the past quarter. However, Opendoor bought 250% more homes than it sold. The current operating structure can support a much larger sales volume, leading me to believe that it is a matter of quarters when Opendoor will post positive free cash flow. In addition to the benefit of growing scale, I expect the unit economics to improve as the company moves closer to the buyer in the transaction, adding mortgages, home improvements, warranties, etc.

Opendoor participated in a high single-digit percentage of transactions in its most mature markets. It bought 0.9% of all homes in the US in the third quarter of 2021. However, this market share should be put in the context of the fastest real estate market in recent memory, where bidding wars are the norm, and the comfort of instant buying is less evident than during the normalized cycle. According to a survey by Redfin, a real-estate brokerage, real estate agents estimate that instant buying will account for more than 20% of residential real estate transactions in a few years.

Suppose Opendoor keeps executing profitably on its strategy. In that case, it should make billions in free cash flow in five years, with a long runway ahead in market share and revenue per transaction, making the current price seem like a bargain.

<u>Uber – increasing our position</u>

Several years ago, a casual observer might have thought Uber's customers and drivers were promiscuous and that its product was a commodity. He would have been right—the competition is always a click away. Under the quiet (for Uber standards at least) leadership of Dara Khosrowshahi, Uber has merged its autonomous vehicle technology unit with Aurora, Uber flying cars with Joby, Uber's scooter business with Lime, and shut down Uber Works. The narrowing of the focus came with the expansion of the product range to food, grocery, and custom last-mile delivery. In addition, it introduced Uber One, a subscription offering that aims to improve the loyalty of its most valuable customers.

In 2021 Uber suffered a widespread shortage of drivers. Afraid of catching COVID-19, drivers stayed at home or delivered food instead. In addition, some drivers were less keen to work given the unemployment benefits provided by the government. The issue wasn't limited to Uber, whose market share in the United States increased, settling at 75% in December 2021. Driver labor is the most significant cost to passengers, and its inflation presents a risk to utility of Uber's service.

While damaging in the short term, disruption during 2021 revealed an unanticipated strength. Years after Uber's ride-share unit proved that superior service could dramatically expand a narrowly defined market, Uber demonstrated that customers are happy to pay significantly more for a ride with Uber than for a cab.[3] While I expect the driver supply to improve in 2022, wage pressures will persist, as driver take-home wage follows broader labor inflation. It is comforting to know Uber's customers care about availability and price.

Uber's food delivery unit was four times larger in Q3 2021 than in Q3 2019. Excellent incremental margins brought it to break-even in the past quarter. It is as essential to Uber today as the rideshare business. Twenty-six years after the first online order, the online food delivery market outside of Asia is down to five players: Uber, Doordash, Deliveroo, Delivery Hero, and Justeat Takeaway. Over the next five years, I expect a vast majority of markets to go from three to two competitors, significantly improving profitability. Uber's operational excellence, cash-generating rideshare business, and a $10bn war-chest will allow it to be number one or a strong second in all the markets where it competes.

We invested in Uber's competitor in the delivery business, Justeat Takeaway, during the fourth quarter. I thought I was making a one-way bet. If the management ran a tight ship and delivered on targets, the prize would be multiples of our investment. Otherwise, given its impact on industry profitability and the inevitable consolidation, Justeat Takeaway was worth more in pieces to its competitors than the market valued the whole.

Unfortunately, within weeks I realized that the investment was a mistake. The error was that consolidation via acquisition is an unlikely path forward for the industry. In a rapidly growing market, excellent execution of the right product-market fit matters far more. In addition, the regulatory landscape is changing in a direction that reduces the chances of the acquisition of Justeat Takeaway.

[3] https://philo.substack.com/p/ride-hailing-is-it-sustainable

Since our investment, Doordash has announced that it will acquire Wolt, a European food and grocery delivery platform. Platforms offering delivery fleets, such as Wolt, Doordash, and Uber Eats, have valuable advantages over marketplaces. They deliver fresher meals due to less frequent stacking of orders. They offer food from restaurants that do not hire their delivery staff. Consumer-facing technology is an order of magnitude better than marketplaces. Waiting for delivery might be a first-world problem, but the hungry customer values knowing where his pizza is, minute by minute.

Justeat Takeaway's core profit centers in Germany and the Netherlands were spared serious competition from delivery operators. However, competition from Wolt will come to its most lucrative markets at a time when Justeat Takeaway is struggling with Uber and Deliveroo in the United Kingdom. In addition to Wolt, a new wave of competitors will likely emerge when quick commerce start-ups such as Gorillaz embrace food delivery. If they don't do it offensively, they will enter to retain their customers.

Justeat Takeaway lost EUR 350m in 2021. On the other hand, Germany and the Netherlands made c. EUR 260m. If (when?) German profits vanish due to competitive pressures, the company will face a challenging situation. I am increasingly uncertain whether the company has the balance sheet or the strategy to succeed in the next decade.

Instead of spreading our bets across the industry, we will concentrate our exposure via our investment in Uber. In the coming years, Uber's virtuous circle will spin faster. Better customer retention will increase demand density, improve driver utilization, make drivers more profitable, increase supply, and enhance demand.

<u>Angi – increasing our position</u>

In 2019 Angi started undergoing a rare type of turnaround. It is not slashing costs, raising prices, or trying to improve the optics of a sinking ship. Instead, Angi is in the process of changing its product to better fit the ecosystem.

Angi's legacy business is a lead generation service for handymen. The transaction starts when customers come to Home Advisor, Angi's website, to elicit offers for jobs such as fence repair. The handymen pay Angi for the leads. Once handymen have the lead, they contact the customer and pitch the project.

Legacy business is a disappointing experience for all parties involved. The handymen are frustrated because the payments for leads do not always turn into actual jobs. This is by design—Angi sends leads to multiple handymen to ensure customers get at least one offer. The customer is not delighted either because they receive calls from multiple handymen and cannot tell how much the project will eventually cost. Revenue potential is capped because it is difficult for handymen to track the return on what they spend for the leads, which limits Angi's share of their ad dollars.

At Angi Services, the customer books, schedules, and pays for the service in one go. Angi prices the service and finds a handyman. As the demand for its service reaches local economies of scale, Angi will get a lower price for the services while allowing the handymen to have higher take-home earnings due to better utilization. Rather than charging for leads, Angi monetizes by taking a cut of the transaction value.

The offering is currently present in many markets across hundred job types. Angi is in the process of adding different kinds of jobs across the country, as well as adding suppliers to its network. Tech-enabled labor-intensive physical infrastructure comes at a high centralized fixed cost, which acts as a barrier that should enable high incremental margins.

The offering resonates with the customers, with a revenue run-rate of $500m, growing organically 80% in Q3. I expect Angi Services to dramatically improve the economics of the overall business and eventually overtake the legacy business as the primary driver of Angi's value.

<u>Exited investment – Peloton</u>

We invested in Peloton in May 2021 because I thought it would have a significant share of a large market. We paid $93 per share. We exited at $37.

What changed, and what has remained the same?

The pandemic caught Peloton's management unable to satisfy the sudden surge in demand. Scarred by the experience, they aggressively expanded capacity in 2020 and 2021. However, as lockdowns receded, potential customers rushed outdoors and were hesitant to make a large purchase towards their home gym.

The first check whether my thesis on Peloton was evolving in the wrong direction was the engagement of current members. Peloton passed the test – members kept using their devices far more than gym members use their memberships. They also used them more than in 2019, while member churn has remained below 10% per year.

The second test was whether the economics would be as attractive as expected. The value of Peloton's business comes from its recurring, high-margin subscription business. While the number of subscribers will grow in 2022, Peloton's overall revenue will decline as units sold will be lower than in 2021. Given all the profits from the subscription service, this would be a digestible problem if Peloton's fixed cost base was not out of touch with reality.

The third test was whether management could accomplish the vision. Unfortunately, the execution took a turn for the worse during the second half of 2021. Key events, product launches, and marketing campaigns became visibly sloppier. For example, the treadmill launch event was organized during working hours on the East Coast, streamed via YouTube, and narrated by seated staff from low-resolution laptop cameras. Peloton Guide, intended as the entry product in the strength category, was announced in November without a demo or an immediate plan for release.

Finally, during January 2022, management hired a pricey consulting firm to help clean the bloated cost structure. Peloton's four founders, still in charge and controlling the board with super-voting shares, prefer paying money to save money instead of owning their mistakes. Such an approach is unlikely to build the durable company I hoped Peloton would be.

Table 1 – Five most significant contributors to returns in 2021

Company	Contribution	Return
Facebook	+4.3%	+21.6%
Interactive Brokers	+4.3%	+31.9%
Peloton	-2.8%	-60.6%
Justeat Takeaway	-2.5%	-30.5%
Angi	-2.5%	-29.9%

Source: Interactive Brokers, consolidated accounts
During 2021 cash averaged 14% of the portfolio