ARCH|Capital

	Arch Capital Investors Fund	S&P 500 Total Return Index
Returns Year To Date	(24.6%)	(20.0%)
Returns Since Inception (2/1/21)	(27.2%)	4.1%

**Fund returns are as of the end of Q2 2022 and net of realized and estimated fees. Returns may differ based on the timing of entry into the limited partnership.*

Contact archcapitalmanagement@gmail.com with any questions.

Dear Limited Partners,

The last few months have been fun, haven't they? As with the vast majority of portfolios with no short exposure, the Arch Capital Fund has dipped into the red in 2022.

While drawdowns are never enjoyable, we take solace in the fact our portfolio companies continue to create value for shareholders by either returning cash flow to us via dividends and share repurchases or reinvesting for future growth. We have a mix of both types of companies in our portfolio, given our agnosticsim towards so-called "growth" or "value" stocks..

So what have we done so far in 2022? Here's a quick summary:

1. **Sold Sprouts Farmers Market**. We entered 2022 with Sprouts Farmers Market (SFM) as the fund's largest position. This was due to our initial position sizing, the stock's great performance, and the poor performance of the rest of our portfolio holdings. In early March, SFM popped 15% and reached a market cap close to $4 billion. This put a double whammy on our expected forward returns for the stock. First, and most obvious, a higher market cap means we are yielding less in cash flow each year. Our bet on SFM revolved around durable (but low growth) cash flow generation that was yielding more than 10% when we purchased shares. At a market cap significantly higher, forward returns would be lower than our 15% hurdle rate. Second, a big reason we liked SFM was management's strategy to pour all free cash flow into share repurchases at a depressed earnings multiple. This attractiveness incrementally goes away at higher and higher share

prices. Combine this with other opportunities presenting themselves with the broad market sell-off this year, and we decided to fully exit our SFM position.

2. **Sold Harbor Diversified**. Harbor Diversified was the most unique stock we have owned. The regional airline (owner of Aire Wisconsin) was purchased for the fund in December of 2021. Our thesis was simple: The stock was trading at less than 1x free cash flow (not a typo) and significantly below a conservative estimate for liquidation value. We believed at the time that the stock had a tremendous margin of safety and upside. The margin of safety came because of the stock trading below liquidation value and the upside from the potential for a contract renewal with United Airlines. In early 2022, the thesis looked to be playing out with continued cash generation from the business and management repurchasing shares at depressed prices. However, when the Q1 10-Q was released, numerous new risks presented themselves. These included a payment dispute with United Airlines, a pilot shortage, and management investing cash in marketable securities. Combine this with the fact shares were now trading in a range possibly above liquidation value, and we decided to sell our position in Harbor Diversified for a small gain.
3. **Sold Swedish Match**. One of our top holdings and the maker of the popular Zyn nicotine pouch got a proposed buyout offer from Phillip Morris International (PMI) in May. Management has accepted the offer. Even though the deal hasn't closed and there is the potential for getting higher returns from a revised deal (an activist investor has recently taken a stake in the company), we decided to sell our position. Why? Simply, because we have zero expertise in merger/activist investing. While we take solace in the fact we were able to sell Swedish Match at a modest gain and that PMI validated our thesis on nicotine pouches, we were extremely disappointed to let go of Swedish Match. Nicotine pouch sales are growing like wildfire across the United States, Zyn has maintained market share even though competitors are pricing products at significantly lower prices, and management was running a consistent repurchase strategy at a depressed valuation (shares outstanding are down ~25% since 2014). This was an easy recipe for outsized returns this decade. Alas, all we have to show for it is a modest buyout premium.
4. **Bought Dropbox** (for the second time). In March, we decided to buy Dropbox with some of our cash position. We had sold the stock in 2021 due solely to valuation concerns, but with the stock cratering in early 2022, we decided to revisit the company. It turns out, the business was still as strong as ever. If you want more detail on why we like Dropbox, you can read our report from back in Q1 here.
5. **Bought Alphabet**. In May we decided to buy Alphabet (parent company of Google, YouTube, and Android). Our thesis was simple. Alphabet has billions of locked-in users around the globe with businesses like Search, Maps, and YouTube that should grow in-line or faster than worldwide GDP. With all the cash these businesses generate, management is able to reinvest in Google Cloud, Other Bets projects like Waymo, and return cash to shareholders via share repurchases. At an enterprise value-to-free cash flow

(EV/FCF) of around 20 at the time of our purchase, we believe this sets up shareholders for low risk 15%+ returns over the next five years.
6. **Bought InterActiveCorp**. Throuhought 2022 we have been buying shares of InterActiveCorp (IAC). At the end of this letter is our recent report on the stock, which you can also find on our website.
7. **Added to multiple existing positions**. With the stock market down and certain sectors putting up huge negative returns in 2022, Mr. Market has given us an opportunity to buy some of our existing portfolio companies at big discounts. This mainly included Wix, Spotify, Autodesk, Match Group, and Consorcio Ara.

Is this more portfolio turnover than you should expect in the average year? Perhaps. But when opportunities present themselves and volatility increases (both up and down) we're not going to sit on our hands simply because of some artificial mandate for low portfolio turnover. Our goal for the fund is to generate 15% returns over the long haul while taking on as little risk as possible, and sometimes that means buying and selling stocks.

But more importantly, we want to update you on what we are not doing. Despite the chaos in the stock market right now, we are not overtrading. We are not looking to buy securities on the belief they will "pop" over the next few months. We are not stretching outside our defined strategy (quality business + stellar management team + reasonable price) for buying a stock. This discipline – especially in bear markets – is how we plan to generate outsized returns for you over the long term.

In the future, as we strive to build value for our limited partners, you should look for us to adhere to a few basic principles. First, we look to invest in businesses within our circle of competence (i.e. businesses we can understand). Second, we look for businesses trading at a discount to the cash they can generate over the next 3 - 10 years. Third, we look for businesses where we can trust the management team to act rationally and intelligently with the cash that is given to them. It is rare to find stocks that have all three of these traits. We only expect to find one of them, at best, each year. But when we do, you can expect us to buy aggressively and hold for as long as our thesis is intact. And of course, we will sell a stock if the valuation gets egregious.

At the end of this letter, you will find a write-up for one of our portfolio companies, **InterActiveCorp** (IAC). We believe the stock is severely undervalued at the moment. Combine this discounted price with a stellar management team, and we think IAC is poised to generate considerable value for shareholders in the coming years.

You can read all of our historical write-ups, letters, and current portfolio allocation at our website here.

We hope you have a great rest of your summer and look forward to communicating with you again in a few months.

Sincerely,

Brett, Brady, and Ryan

The Best Time to Buy IAC Was Yesterday. The Next Best Time is Now

Our goal for investors in the Arch Capital Fund is to compound capital at 15% annually while taking on as little risk as possible. This *does not* mean risk in the form of short-term stock price movements but *does* mean in the form of durability and future earnings power of the businesses we own.

At $71 a share, we believe **InterActiveCorp** (IAC) is one of the lowest-risk bets to have market-beating returns over the next 1, 3, and 5 years. The long-running acquirer and builder of internet brands has a fantastic track record since its inception in 1995 (13% total return CAGR vs. 10% in the S&P 500), even with its shares plummeting 44% so far in 2022.

At a market cap of $6.55 billion, the stock is severely undervalued vs. its potential earnings power over the next few years. Combine this with a rational executive team, $1.3 billion in dry powder, and acquisition candidates trading at depressed prices, and we are excited about the future potential for IAC shares.

Don't worry, this is not a sum-of-the-parts pitch, but we will outline what gets us excited about owning IAC over the next 12 months and beyond. But first, a brief history of this idiosyncratic conglomerate.

Note: IAC uses adj. EBITDA as its standard financial metric. We understand this isn't the best metric for encapsulating what value is getting created for shareholders, but we have to take the cards that are dealt to us. Plus, with the asset-light nature of these internet brands, IAC's businesses should have strong conversions from EBITDA to free cash flow.

History

IAC was officially started in 1995 when the company (called Silver King at the time) named Barry Diller Chairman and CEO. Diller was CEO until 2010 and is still the chairman today. The current CEO is Joey Levin, who got the job in 2015 after working at IAC since 2003. He is under a 10-year contract and, from what we can tell, is set on staying at IAC for a very long time.

IAC's acquisitions started in 1997 with a 50% purchase of Ticketmaster, and management hasn't stopped buying companies since. You can look at the full history here and here. The most important acquisitions have been Expedia, Match.com, Tinder, and Vimeo, among others. There are also minority investments, including a recent large purchase of MGM Resorts stock that currently is worth around $1.85 billion.

Unlike other conglomerates, IAC acquires and incubates companies with the goal of eventually spinning them out as their own publicly traded entities. The prime example here is Match Group, the online dating roll-up that started with IAC's purchase of Match.com in 1999. The company eventually bought and built the leader in the space (Tinder), making it a runaway success as an acquisition. When the subsidiary got large enough, IAC decided to spin-out part of its equity in a 2015 IPO and eventually did a full spin-off in 2020. Today, Match Group's shares trade at a market cap of $19 billion. This has also occurred (with varying degrees of success) with Expedia, Live Nation, Vimeo, and Trip Advisor.

The key takeaway for us is that when IAC builds something, it is not afraid to let it go and chart its own corporate destiny.

1-year horizon: Turo IPO, Dotdash Meredith rebound

Today, after all the spin-offs, IAC is comprised of these assets:

- ~85% ownership interest in Angi, which is a publicly traded stock. We just treat it as an equity stake valued at $2 billion (as of this writing)
- ~15% stake in MGM Resorts (IAC's interest valued at $1.86 billion)
- 27% stake in car sharing start-up Turo (IAC's stake currently valued at $250 million)
- Majority investment in Vivian Health (IAC's stake valued at $300 million)
- Dotdash Meredith publishing division ($2.3 billion in trailing Pro-forma revenue)
- Ask Media Group (generating over $100 million in annual adj. EBITDA)
- Care.com ($340 million in annual revenue)
- $1.9 billion in cash ($1.3 billion at the parent company)
- $2.1 billion in debt

We believe two of these assets have the most potential to catalyze shareholder value in the next 12 months: **Turo** and **Dotdash Meredith**.

Turo

IAC has an approximate 27% stake in car sharing start-up Turo that can be increased to around 35% with the exercise of its outstanding warrants. IAC acquired this stake back in 2019 for $250 million. The investment is still held at its cost today.

Turo is an online marketplace that enables people to rent cars in a peer-to-peer model. This could mean a rental car for a vacation, a joyride in a sports car, or for whatever (legal) purpose a customer desires. Given how terrible the experience is renting from a traditional service, we believe Turo will have an easy time displacing legacy competitors like Hertz over the next decade.

The evidence is already here that this is happening in spades. In early 2022, Turo filed its S-1 with the SEC in preparation for an IPO. In 2021, the company generated $469 million in revenue, up from only $150 million in 2020 and $142 million in 2019. Through the first quarter of 2022, this stellar growth continued, with revenue hitting $143 million, up from $56 million a year prior. Some of this strong growth is due to the pandemic recovery, but it is still phenomenal growth nonetheless.

Turo's gross margins are also strong, at 57% in 2021 and 51% in Q1 2022. The company isn't generating consistent operating income or free cash flow, which makes it tough to value, but with strong unit economics and a huge legacy industry to go after, we think it is smart for Turo to pour money into growing its revenue as fast as possible. With the money that will be raised from this upcoming IPO, the company will have a large war chest to continue this strategy.

If Turo is going to IPO, it will likely be within the next 12 months. The company is on track to do around $600 million in revenue this year (maybe higher) and is on pace to hit $1 billion in annual sales within the next few years. With relatively strong unit economics, it is not unreasonable for the market to value this business at $3 billion when it goes public (of course, in this environment, it might be a little less). If IAC's stake is 30% after the IPO dilution, that would be worth $900 million, or 3.6x its original investment in 2019. Not bad work, if you can get it.

With an enterprise value under $2.5 billion excluding Turo (but including Angi as an equity stake), IAC shareholders will benefit greatly when the company goes public within the next 12 months.

Dotdash Meredith

Valuing the Turo investment at $250 million, IAC's enterprise value is approximately $2.15 billion. This is severely undervaluing the earnings power of its operating businesses.

You have the Search/Ask segment, which generates over $100 million in adj. EBITDA. However, this business is in run-off mode and is likely not worth much more than a few hundred million dollars to IAC shareholders today.

The most important operating segment is Dotdash Meredith, a publishing house for various brands like People Magazine, Better Homes & Gardens, and even Investopedia. In late 2021, IAC acquired Meredith's publishing division for $2.7 billion and combined it with its existing publishing segment called Dotdash. Thus, Dotdash Meredith was born.

IAC's strategy with these new properties (which have a monthly audience of 144 million, significantly more than the 96 million at Dotdash) is to modernize their advertising strategy and cut out poorly performing print magazines. Modernizing the advertising strategy means fewer but more effective advertisements by focusing on commerce and performance marketing. For example, on a per-user basis, Dotdash's properties were getting more than twice the amount of performance marketing revenue as Meredith's before the acquisition was closed.

But in order to make these changes, IAC has to rip out Meredith's old systems, sacrificing some revenue in the process. This is happening right now, and when combined with a slowdown in internet advertising, is making Dotdash Meredith's business look really poor. For example, on a Pro-forma basis, Dotdash Meredith's digital revenue was down 18% year-over-year in June. In a vacuum, this looks bad, but once you understand IAC's strategy and how much value it can create for these brands over the long term, this short-term hit is worth it.

Why is this Dotdash advertising strategy so valuable? Well, the proof is in the pudding. From 2018 to late 2021, Dotdash's digital revenue compounded at 32% a year using this same strategy, with adj. EBITDA growing from $21 million to $88 million over the same time period. We don't expect 30% revenue growth from the newly combined company, but it is not out of the question for digital revenue to grow at 10%+ a year once these repairs on the Meredith websites are done.

IAC is guiding for Dotdash Meredith to generate $450 million in adj. EBITDA in 2023. With an enterprise value close to $2 billion, the market clearly doesn't believe this can happen, given where shares are trading. If the segment can reach these profitability goals (and we think they can), the stock should re-rate higher at some point over the next 12 months. Looking out a few years, the segment can easily generate IAC's entire current enterprise value in cash by 2025, especially if you include the cash generated by the Ask/Search group.

However you slice it, IAC stock is trading at an incredible discount right now.

3 - 5 years and beyond: Capital allocation track record

We like IAC's prospects over the next 12 months. But with all of our investments, we plan to hold for at least three to five years, and hopefully longer. Since IAC is just a holding company, there isn't much we can forecast on what its consolidated earnings will be in 2025. No, with IAC, it all comes down to trust in Diller, Levin, and the rest of the team to smartly allocate shareholder capital.

It may sound overly simplified, but with a 25+ year track record of beating the market, it is hard not to trust the team at IAC to do right by shareholders. Of course, we can never ignore price when buying a stock, which is why we are pounding the table to buy shares today.

Investors should also consider the current economic/business landscape with many start-ups, technology, and internet businesses seeing their market values decimated over the last year. IAC, with $1.3 billion in pure dry powder and an easy ability to find more funding from capital markets, looks poised to acquire some of these distressed (or soon to be distressed) assets at dirt cheap prices.

It is unclear what investment will be the next big winner for IAC. It could be Care.com, Angi, Turo, Vivian Health, or some other business yet to be acquired. But we don't need to know this information to invest today. As long as the culture that created these market-beating returns is still guiding this ship, we are able to sleep well at night holding our shares.

Closing thoughts

To sum it up, IAC is trading at a cheap price relative to its current earnings power, has a long-tenured executive team with a great track record of creating shareholder value, and is coming into an operating environment ripe for easy acquisitions. What more could you want in a portfolio company?