

November 13th, 2022

Dear Partners,

In this letter I'd like to lay out some of my thinking on how I am investing through the current environment.

In our Partners' Manual, I laid out our goal: to compound our money at high rates of return while making my best efforts to continually maintain safety of principal. I view the two clauses of the goal as self-reinforcing. If we do not lose a significant amount of capital, then we are more likely to have the stomach and clear thinking required to bet heavily on the very best opportunities, ones that could catapult our capital forward. Coming back from a serious drawdown is certainly not impossible, and such a situation will likely be inevitable at some points during our 30+ year journey, but I'd like to delay it for as long as possible.

How do we define the environment we are in? We don't attempt to predict the macroeconomic future, but we do spend time trying to see clearly the state and fundamental momentum of the present; and against that backdrop, we try to assess the attractiveness of the risk-rewards presented to us. We note the continued high growth in wages (6-7%) and lack of slack in the labor market, the current risk-free rate (4%) vs. the dividend yield+growth estimate of the S&P, the Fed's anticipated hiking path, and the steadily weakening business momentum of the companies we follow. Our response is not to trade on anticipated movements in the market, for which we have no idea; rather, our response is to *raise our hurdle rate* for our investments and use that as the basis for our decision-making. Since launching the fund, I have set our general hurdle rate at a 30% 4-year IRR, whereas in normal times it might be 20%. In other words, we are taking the view that, forecasted conservatively, a 30% IRR is a heavily mispriced bet worth making in this environment despite the macroeconomic risks.

How do we minimize losses in this type of environment? Our approach is to bet only on the most attractive, highest IRR opportunities, and to cut position sizes quickly when our investments fall below our hurdle rate. In practice, this means our position size in the same company could vary dramatically based on its price and our constantly updating view of its long-term fundamental potential. This leads to a lot of trading, but we are not traders; we are simply updating position size to its appropriate amount given changing conditions. We bet only on the best opportunities, are willing to rotate quickly even from companies we love into better opportunities, and are willing to hold cash when opportunities meeting our high bar (much higher than usual in this environment) are not available.

In some ways this is not a controversial or particularly novel approach. However, most funds don't do this, because of a couple of factors: 1) they believe philosophically in long-term investing, which means holding high-conviction positions through good and bad; 2) they (wisely) believe that precise IRRs are not knowable and such active trimming may lead to missing out on big winners; 3) there is an institutional bias, both from within the fund and from external allocators, that they always run fully invested; and 4) their fund size does not permit such active position size management given liquidity constraints.

My thinking on these topics is:

- 1) I believe strongly in long-term thinking, and in doing such deep research that we deserve to hold our long-term views. However, for me, long-term thinking does not necessarily mean long-term holding. I absolutely love studying quality businesses and am always looking to add to our repertoire of companies that we've researched deeply and hold long-term views on. We fall in love with companies but not holdings; and from our pool of loved companies, we continually pick a portfolio of the best opportunities.

- 2) This is a wise pushback to our approach; I acknowledge that we may miss big winners that continue to appreciate long after we've trimmed or sold. In normal times, I would be more willing to let winners run and to relax our IRR limits as existing holdings appreciate. However, I believe that changing circumstances require changing tactics. Our approach to trim and add tightly based on IRRs in an adaptation to the current environment.
- 3) In normal times, I would also lean towards staying fully invested. In the current environment, I am willing to hold cash at times because I believe it provides optionality, reduces drawdowns, and ultimately maximizes our returns. So far, varying our levels of cash based on the opportunity set/IRRs available has paid meaningful dividends. We ramped up to fully invested in late June, cut positions significantly in July and August as they appreciated and IRRs declined, and as a result avoided some losses and had substantial buying power all the way down in September, October, and now November.
- 4) This is a huge advantage for us as a small fund, to be able to take advantage of volatility by adjusting position sizes quickly. I've spoken to other managers who say they would love to position manage more actively but cannot.

We fall in love with companies but not holdings. When the opportunities shift, we shift our portfolio as well. One recent shift I've been making is in dramatically expanding our exposure to US software.

When we launched the fund on May 1st, our exposure to software was zero, for the simple reason that valuations/IRRs looked unattractive vs. those of our other ideas. Smartsheet was trading for 8x NTM sales, Okta 10x, and MongoDB 20x. Today, Smartsheet trades for 4x NTM sales, Okta 4x, and MongoDB 8x. Our forecasted IRRs went up dramatically, and as a result we've established meaningful positions in all three. Fitting with our investment philosophy, all three have great products that deliver incredible value to customers. (In the appendix to this letter I've attached our recent writeup on Smartsheet.) Our current software exposure sits at 32%.

Why do we like software so much in this environment?

- 1) There is an abundance of companies that focus on the customer and create amazing products, which fits the core of our investment philosophy. Furthermore, there is a huge amount of growth left for the sector, driven by the mega-trend of digital transformation.
- 2) We can invest in companies with mission-critical products that customers pay for on a recurring basis and cannot turn off. Unlike in B2C, for our companies, negative revenue growth is effectively not possible. At the start of each year, quality software companies know that they've locked down all the revenue they had previously, and in fact can anticipate meaningful growth from existing customer expansions even if zero new customers are added. Rather than whether revenues grow, the main question becomes *how much* revenues grow by, e.g., 20% vs. 30%. If expectations and valuations are high, then small variances in anticipated growth can have significant impacts on stock price, as we've seen; but when valuations become bombed out and reach low-to-mid-single digit sales multiples, as they are now, from a fundamental perspective that becomes less relevant. Despite customers becoming much tighter on scrutinizing software spend, we think fundamental prospects are brighter in B2B software than in B2C. Large B2B enterprise customers are forward-looking and are cutting software spend ahead of weakness in the broader economy, whereas ordinary consumers react more to latest conditions as they happen. Consumer spending has still held up OK to date and thus has the potential for meaningful further negative revisions, whereas the cutting is already ongoing in B2B.
- 3) B2B software companies are more resilient to margin pressures than B2C companies are. In these inflationary times, we've seen many B2C companies blow up on margin, with associated large declines in their stock prices. B2B software is more resilient because it is well understood that 1) gross margins are extremely high, with opex in large part driven by investments for the future; and 2) B2B software trades more on potential than actual margin, because the path from high growth/low margin to low growth/high margin has been proven repeatedly for quality companies in the sector.

- 4) Valuations have become bombed out. The median software company NTM revenue multiple has declined from 15x sales in January to 5x today, a level well below even pre-covid averages.

Versus other opportunities available today, quality software seems to have the optimal combination of defense and offense. Defense in that these business models are incredibly resilient and will not fall apart under almost any scenario; offense in that these business characteristics and growth potential are generally understood by other investors, who as a result will likely look to pile back in upon seeing signs of a risk-on rally (as we saw in August). Major losses sustained by software investors YTD and major earnings misses in recent weeks have combined to cause panic in the sector, which we have been taking advantage of.

As the opportunity set changes, we change as well. If the market continues to be volatile, as seems likely to be the case, you should expect our portfolio composition to continue to shift. However, our North Star in idea selection remains the same: to only invest in companies with great products (which drives our conviction in terminal value), to do deep research and take long-term views, and to make big bets on the very best opportunities.

As always, I am immensely grateful for the opportunity to manage our capital and am hard at work trying to compound it at the highest rate that I can.

Yours,

Timothy Liu

Below I am attaching a writeup on Smartsheet, one of our largest investments.

Smartsheet Memo – 10.6.2022

Smartsheet is an online spreadsheet that is purpose-built for collaboration, containing so many features that Excel and Google Sheets lack that for many customers, it completely changes the way they work and becomes a mission-critical part of their operations. Customer feedback for Smartsheet is exceptional, which is a big part of what gets us so excited about the company. Multiple customers have described Smartsheet to us as a “Swiss army knife” application to solve a myriad of important use cases, many not addressable by other tools.

The power and utility of electronic spreadsheets has been proven over decades, and the history of their predecessor paper ledgers goes back centuries. Spreadsheets are a natural way to represent many business operations: one row per subject, with a series of columns containing information about that subject. Microsoft Excel was released in 1985 and, 37 years later, is still going strong, powering innumerable business processes and operations (including ours). If one can truly build a better Excel for a subset of use cases, then that has the potential to be a large business that creates enormous value for customers. The degree to which customers deeply rely on Smartsheet today suggests that they have done so.

Microsoft Excel is a phenomenal product, but it was not designed for collaboration. Additionally, the age of the product and the deeply entrenched habits of its longstanding users means that it is very difficult to make major changes to it. In a company environment, use of Microsoft Excel for collaboration has several key weaknesses, including version control (emailing files back and forth and searching for the latest version), difficulty of use for non-power users, lack of automation and notification features (which are important for task assignment and workflow automation amongst colleagues), lack of integration with other business applications (to pull in data easily from other platforms like company databases), and lack of easy-to-use dashboarding capabilities (to show aggregated results to management and track data over time) – all of which are problems that Smartsheet solves. Google Sheets is online and solves the version control problem involved in collaboration, but is otherwise fairly simple and missing most of Smartsheet’s features. Comparing Excel and Google Sheets to Smartsheet is a little like comparing WhatsApp to Slack – nominally they are both messaging platforms, and work very well for their own use cases, but Slack has completely redesigned messaging for the enterprise.

Smartsheet’s customers use it to power mission-critical use cases. To list a few examples that we’ve heard from conversations with customers:

- Starbucks used Smartsheet to coordinate installing Nitro Cold Brew equipment in 4,300 stores in 12 months. Smartsheet was used to synchronize data with Starbucks’s database system, share data with design companies, and manage multiple general contractors. Without Smartsheet, Starbucks would have required at least 4-5 additional employees to do data entry and management.
- Starbucks runs its store closing notification process on Smartsheet: informing the lease administration team to stop paying rent, informing the technology team to turn off all the store’s technology systems, instructing the supply chain team to stop shipping products as of a certain date, etc. Previously, this was a manual and incredibly time-consuming process involving 40 steps that the real estate team was able to consolidate down to 4 using Smartsheet.
- The Special Olympics USA Games ran its entire 2022 Games on Smartsheet. Smartsheet was used to coordinate equipment (iPads, bleachers, chairs, bike racks, microphones, etc.), interface with athletes and coaches, coordinate with vendors, create dashboards which were shown to the CEO and used to run team meetings, coordinate schedules and event timing, manage volunteers, publish data to the mobile app for the Games, etc. In previous games, this work was done in Excel, Word, email, and an inferior project management software (Igloo) that everyone “hated” and was “terrible.” The CIO of the Games estimated that Smartsheet enabled the Games to run smoothly, saved the organization at least 3 full-time employees, and avoided wasted procurement by not having to over-order to cover estimation errors.

- Cisco has standardized on Smartsheet across the organization and uses it to manage projects, budgets, OKRs, sales support, etc., both within and across teams. In meetings, Smartsheet dashboard outputs have commonly replaced PowerPoint slides. 50,000 of Cisco's 83,000 employees now use Smartsheet.

Every customer we spoke to told us that the switching cost from Smartsheet would be very substantial and certainly not worth the magnitude of cost savings involved. Two customers said that if forced to switch they would personally quit! Once Smartsheet is embedded in a company's workflows, the switching cost is very high because Smartsheet usage is data-intensive and often used for operations and reporting as opposed to simply project/task management. A lot of data flows in (pulled from other company applications via integrations) and out of Smartsheet, which makes it hard to replace. Data lives *in* Smartsheet rather than just being referenced by it.

This switching cost is reflected in Smartsheet's very low churn numbers. Smartsheet's gross dollar churn has been steadily declining over time and in 2Q22 reached <4%, down from 11% at around the time of IPO. The company has also previously disclosed that gross churn is ~2% for customers spending >\$5,000, which would put it among best-in-class for enterprise software.

Competition

The biggest misperception of Smartsheet by outsiders is that the space is very competitive with lots of funding – thus, how can we be sure of Smartsheet's long-term competitive advantage? In the collaborative work management space, Asana and Monday have IPO'd and are both >\$5 billion market cap companies; ClickUp recently raised \$400 million at a \$4 billion valuation and Airtable \$700 million at a \$11 billion valuation; Citrix acquired Wrike (\$2.3 billion) and Adobe acquired Workfront (\$1.5 billion). Asana and Monday have also out-grown the bigger Smartsheet in percentage terms, though Smartsheet has held its own in terms of strong absolute growth (43% in 2021 & my estimate of 39% for 2022).

When diving into the details of the products and use cases, however, it's clear that Smartsheet is a very different product than Asana, Monday, and ClickUp, which are purpose-built for project management/task management. No other company has the spreadsheet-like product and thus the spreadsheet-enabled use cases of Smartsheet (with the exception of Airtable, which is the most similar); in practice, Smartsheet can be more of an operational system of record than just a project management tool. Smartsheet has project management functionality (including boards/tasks) and can replace the others if a company standardizes on Smartsheet (with some examples of that recently), but the others cannot replace Smartsheet. This will also vary by department; operations-heavy departments like business operations, finance, and IT will lean toward Smartsheet, whereas other departments like marketing, HR, and legal looking for pure project management solutions may lean toward Asana and Monday.

In each of the mission-critical use cases we discussed earlier, the customer said that Asana or Monday would have not been sufficient for the task. One fundamental difference is that Asana and Monday are not oriented around spreadsheets but rather around boards and tasks. The advantage of this approach is that Asana and Monday are easier to start on, have prettier UI, and appeal to users who aren't used to spreadsheets. The downside, however, is that Asana and Monday don't have a lot of the power and functionality that would derive from spreadsheets. They handle tasks rather than large volumes of data. In some ways Smartsheet is true enterprise software, running operations and handling data at scale, whereas Asana and Monday are software used by employees and teams in an enterprise.

Thus, I think Smartsheet will have a large sub-segment of the collaborative work management market to itself. Where the impact of competition does show up is in terms of new customers and use cases potentially addressable by Smartsheet that are taken away by competitors (e.g., pure project management activity that involves assigning and tracking tasks but does not require any spreadsheet functionality). Going back to Smartsheet's 2018 IPO, one could have argued at the time that Smartsheet will hold a dominant share in what will be a huge collaborative work management market. Fast forward to now, and it's clear that market share in that market will be much more fragmented than previously thought, with different tools addressing different use cases and Smartsheet not being the best tool or having the best brand for some use cases. However, that doesn't mean that Smartsheet won't have a large and protected niche, with *substantial* growth in that niche within existing customers (Smartsheet has a phenomenal 130%+ annual net revenue retention, driven by viral growth within organizations) and from new customers that need its unique use cases.

Smartsheet has particular traction in enterprise customers, whereas Asana and especially Monday customers skew smaller. Smartsheet has 1,220 customers (+63% y/y in 2Q22) with ARR of >\$100k and 36 customers with ARR of >\$1 million; 50% of ARR comes from companies with >2000 employees. Smartsheet has 131% annual net revenue retention across its entire customer base, which ramps up to 149% for customers >\$500k ACV and 163% for customers in the Fortune 100! What's fascinating is that \$100k ARR is actually quite a low threshold of Smartsheet usage; at \$30 per paid user per month, that represents only 278 paid seats. Accounting for a typical 1:6 paid-to-free user ratio (free users can add rows and edit cells but cannot create sheets or add columns), that works out to ~1,900 employees using Smartsheet, whereas total employee counts at large companies can get much larger. All in all, historical cohort data and our own research suggests that there is continued room for major growth within Smartsheet's existing customers. 80% of companies in the Fortune 500 are Smartsheet customers.

I believe some in the market view Smartsheet simply as a "share loser" to faster-growing competitors. Share losers are hated in public markets, viewed as "melting ice cubes," and assigned very low multiples. However, while "share loss" is true in mathematical terms using the whole collaborative work management market as a denominator, with Smartsheet growing slower than some competitors, this is the wrong lens to view the company. Smartsheet is a very *different* and unique product addressing a huge market of its own, one with large portions not overlapping with that of competitors.

Collaborative work management is going to be a huge category. It's very clear that the way we work – assigning tasks with email and Slack, sending Excel sheets back and forth, saving documents and assets to SharePoint, trying to manage projects and track deadlines manually or through legacy products – is outdated and inefficient, and would benefit greatly from having a software layer that augments our capabilities. I'm keeping a close eye on Asana and Monday as potential investments, though at current valuations I believe Smartsheet is by far the most attractive investment of the three.

Valuation

Through most of its history, Smartsheet has traded at 12-15x NTM sales. Recently, however, Smartsheet's multiple has de-rated to 5x NTM sales without a material deceleration in growth or other key metrics (though as with almost all enterprise software companies, macro is expected to be a hit to 2H22 results). This provided us an opportunity to accumulate a substantial position.

I expect Smartsheet's revenue to CAGR at a 27% rate from 2022 to 2027, reaching \$2.5 billion in calendar 2027 from \$764 million this year. If we exit at a 5.5x NTM revenue multiple, a slight increase from the current depressed multiple of 5x NTM, then (incorporating dilution and cash) we derive a 26% IRR (2.5x return) to year-end 2026.

Like for other quality enterprise SaaS, I believe a 5.5x revenue multiple is well-supported by the growth and long-term margin potential of the company, which one day if at low growth should be well above even the 20% “long-term” operating margin (ex-SBC) guided by the company (that guidance assumes continued relatively fast growth at that point). This year, the company is guiding to -9% operating margin (non-GAAP) and breakeven free cash flow. 57% of revenue is going into sales & marketing, which is driven by (and drives) the company’s 39% revenue growth, and which would decrease substantially if growth were to slow. The company should also continue to gain operating leverage from the R&D and G&A lines, as has been the case over the past several years.

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