MOI GLOBAL

An Update on System1 Group

This article is excerpted from a letter to partners of Boyles Asset Management.

System1 Group has been a large swing factor in the fund's performance during the year. Shares peaked at the end of May at around 1000 pence (p), adjusted for a special dividend. After ending Q2 at approximately 814p, the shares closed Q3 down 35.5% at 525p.

In our Q2 letter, we highlighted the company's statement that growth was "a little slower than we expected." While we were of the belief that this wasn't a meaningful issue, in August the company reported that the trends worsened considerably, and the company would report a *decline* in net revenue in the high single digits. Given that the company was investing especially heavily this year in support of future growth, earnings would fall for the year and approach break even in H1 (the company has since reported a result much better than break even, but materially lower than in the prior year). This was a decidedly negative and remarkably abrupt change in business conditions.

In the prior three reported periods, net revenue growth on an organic, currency-adjusted basis was 11% in H1 2016, 18% in H2 2016, and 16% in Q1 (calendar 2017). The culprit could be found primarily in a single product line that has been severely impacted in the short term by the abrupt and significant changes that large consumer goods companies are making with their marketing and market research expenditures. In fact, System1 drew a straight line to the failed bid for Unilever by Kraft Heinz.

System1 has guided to a better H2 with revenue growth, but the market is rather suspect. While it has been painful during the last couple of months, we believe the company's investment in future growth is warranted and that it is prudent (at this stage) that the company forge ahead with that investment despite the significant impact on earnings in a soft revenue year. If we were to recalibrate our thesis, in light of recent industry and business conditions, we would have to acknowledge that the company's exposure to large global consumer multi-brand businesses, for which System1 has a small share of spend, may not be the tailwind we envisioned. While there remain some short-term concerns about earnings in H2, and we may have to adjust our belief in the tailwind just referenced, we believe the internal rate of return (IRR) potential over a long period is now significant, and that the company has returned to "temporary trudger" status (see our 2017 Q1 letter for a description of this investment category mental model).

One might wonder why we did not sell shares earlier in the year. We do believe that, for a brief period, the shares approximated fair value. While we did in fact sell a few shares, surprisingly they remained relatively illiquid throughout the year, especially so at the highs. Our thesis going into the investment—that as the company grew, performed well and attracted more attention, the shares would become more liquid—did not transpire during 2017. Our decision not to sell more aggressively, perhaps needing to be done at sizable discounts to the market price, was driven by the many great characteristics of the business that still remain true today: the potential to be meaningfully larger in time, a strong free cash flow generation model even while growing, minimal capital requirements, strong financial management, and last but not least, a fanatical owner-operator.