HAYDEN CAPITAL

QUARTERLY LETTER

2024 | Vol.3

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November 27, 2024

Dear Partners and Friends,

With the US elections over, it seems like animal spirits are back in certain pockets of the market. Anticipating incoming President Trump's "America First" policies, economically sensitive stocks, crypto, and presidential "favorites" (looking at you Tesla) have been rallying recently. I don't know what the next four years will look like, but I'm sure it will be interesting.

Time Period	Hayden (Net)[1]	S&P 500 (SPXTR)	MSCI World (ACWI)
2014[2]	**(4.9%)**	**1.3%**	**(0.9%)**
2015	**17.2%**	**1.4%**	**(2.2%)**
2016	**3.9%**	**12.0%**	**8.4%**
2017	**28.2%**	**21.8%**	**24.4%**
2018	**(15.4%)**	**(4.4%)**	**(9.2%)**
2019	**41.0%**	**31.5%**	**26.6%**
2020	**222.4%**	**18.4%**	**16.3%**
2021	**(15.8%)**	**28.7%**	**18.7%**
2022	**(69.2%)**	**(18.1%)**	**(18.4%)**
2023	**56.6%**	**26.3%**	**22.3%**
1st Quarter	12.9%	10.6%	8.2%
2nd Quarter	7.0%	4.3%	2.9%
3rd Quarter	13.9%	5.9%	6.4%
2024	**37.6%**	**22.1%**	**18.5%**
Annualized Return	**12.5%**	**13.1%**	**9.5%**
Total Return			
1 Year	**66.9%**	**36.4%**	**31.8%**
5 Years	**110.7%**	**109.9%**	**77.6%**
Since Inception	**219.5%**	**238.6%**	**145.2%**

1 Hayden Capital returns are calculated net of actual fees directly deducted from client accounts, for the period from inception (November 13, 2014) to December 31, 2020. Starting on January 1, 2021, reported performance is reflective of a representative account, managed in accordance with Hayden's strategy with no client specific investment guidelines or limitations, made no subsequent investments or redemptions, and remains invested. The representative account paid a management fee of 1.5% and incentive fees of 0%. Clients who elect the performance fee option for their accounts may pay higher fees and therefore realize lower net returns, during years of strong investment performance. Individual returns may vary based on timing of investment and your specific fee schedule. Performance results are net of expenses, management fee and incentive fees. Past performance is not indicative of future results.

2 Hayden Capital launched on November 13, 2014. Performance for both Hayden Capital and the indexes reflects performance beginning on this date.

We have a global portfolio, that I believe is well prepared to handle (and perhaps even benefit from) whatever direction the world heads next.

For example, it looks like we'll finally have a crypto regulatory framework in the US, which benefits our long-held Coinbase investment. Or if geopolitical tensions continue to heat up, I anticipate SE Asia may be the biggest beneficiary, as both the US and China compete to influence and invest in the region.

Even for Chinese companies looking to sell into the US market (which at first instinct, is the most precarious position to be in), I suspect a mutual solution will be worked out in time.

Particularly, it appears the Tiktok US ban is going to be reversed. And Chinese consumer brands continue going global at an accelerating pace – the likes of Luckin, Miniso, HeyTea, Haidilao, Jiumaojiu, Li-Ning, and others. Politics aside, American consumers still want delicious food and good products. Even BYD, which has been in the spotlight recently, may find a way forward by following the path of Toyota in the 1980's[3].

Appealing consumer products will always find customers, and market forces tend to be stronger than geopolitics after all. As long as the rules are clear, I believe innovative companies will always find ways to survive and thrive.

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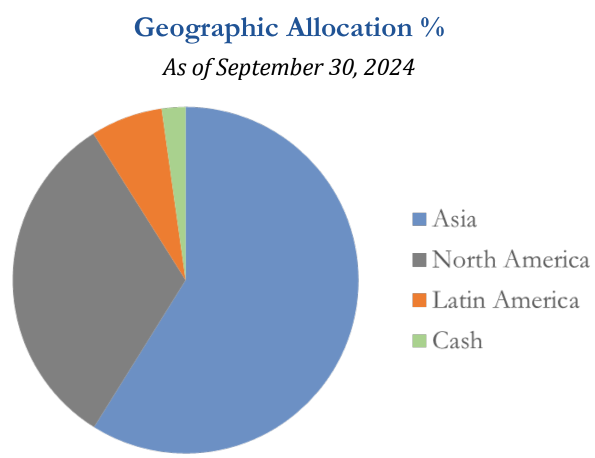

Our portfolio was up +13.9% in the third quarter, compared to +5.9% for the S&P 500 and +6.4% for the MSCI World indices. We have compounded at a +12.5% annualized net return, since inception.

[3] For example, when faced with similar US protectionist restrictions four decades ago, Toyota chose to build domestic factories that avoided such restrictions. US auto makers were struggling to compete against companies like Toyota, so the US government instituted quotas on how many Japanese cars could be imported into the country, called "voluntary export restraints". This resulted in Toyota setting up local manufacturing for the first time in 1986.

Ultimately business quality improved as the company was forced to compete on a global standard, and its revenues diversified geographically. The stock has gone up over 50x since then.

The Trump administration has already expressed willingness to allow BYD and its competitors to sell cars in the US, as long as they set up domestic factories. Firms like CATL are already warming to the idea (LINK).

Approximately ~59% of our assets are invested in Asia and ~32% in North America. We made a new investment in Latin America this quarter, which currently comprises ~7% of assets. In addition, we bought a new tracking position in Japan. The remaining portfolio is in cash.

"Back In My Day…"

I often joke that investors spend so much time analyzing other people's businesses, but so little time analyzing their own. If you were an objective third-party, would you want to invest in a relatively commoditized industry, with 10,000 other competitors, a long product-feedback cycle, an equally long sales cycle, and often zero terminal value? That's what most investment firms are.

Some of us are crazy enough to do it regardless, only because we can't dream of doing anything else and are fueled by passion. But if we're going to do it, we should at least be clear-eyed about the state of the industry and where it's going.

(Note, the following are just my initial, "half-baked" thoughts. I would love any feedback on these ideas. The initial spark for writing this, was several discussions over the last few months with partners who ran funds in the mid-2000's. And of how much more mature the industry has become over the last two decades, and what's to come next).

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I've been traveling a lot over the last few months – which means plenty of flight time for investing podcasts. And a consistent theme in these manager interviews, is the belief that the market structure is changing, often for the worse…[4]

Now, I don't like complaining for complaining's sake. But after some reflection of my own journey in this industry over the last dozen-plus years, I have to say that I agree. At the risk of sounding like a grumpy, old man – I feel like the markets "aren't what they were back in my day…".

It seems like there's more volatility these days – especially around earnings. And markets are quicker to react to "headline" numbers, but slower to process underlying operational changes and to act as counter-balance to irrational knee-jerk reactions. Momentum is in, but value-discovery is out…

This is despite US household stock ownership rising +20%, and the financial industry becoming more mature over the last decade. Yet it feels like the market's become less efficient during this time[5].

[4] A couple examples are David Einhorn of Greenlight on Masters in Business (LINK), Ricky Sandler of Eminence on Capital Allocators (LINK), Andrew Brenton of Turtle Creek on We Study Billionaires (LINK), and Harris Kupperman of Praetorian on Other People's Money (LINK).

[5] US stock ownership stands at ~61% as of 2023. This compares to 52% in 2013 (LINK).

Especially for companies without ETF support or long-tenured investors. Companies less than $10 Billion market cap, companies in emerging markets, recently IPO'd companies whose stories aren't well understood, or emerging technology companies with optically expensive valuations. There are just fewer active investors digging into these "leftover bin" companies.

So what's driving this change? Sure, some of it is cyclical (the last few years have been volatile with Covid, the tech recession, rising interest rates, etc. – so investors have been seeking low-volatility strategies).

But I've also come to accept most of it is structural – our industry is naturally entering a maturation phase – just like those of the companies we study in our portfolios. And to understand where we are today, we should understand how we got here too.

All industries have lifecycles. The 1980's and early 90's, were what I'd consider the hedge fund industry's "proof of concept" stage. There were a few hundred funds that raised capital from a core group of adventurous investors[6]. It was a small cottage industry, "clubby" in a sense, with fund managers and their backers all knowing each other[7].

By the late 1990's and early 2000's, these pioneering funds had proven the diversification and return benefits of the more aggressive "hedge fund" style vs. their conventional mutual fund peers. These attributes started to attract institutional capital, and hedge funds became an "asset class".

With this flood of demand, the funds who launched in the 1990's or before, and had established track records and brands, started to capture much more attention (and assets). Yet demand for hedge funds still overwhelmed these incumbents.

So like in any other capitalistic industry, a new wave of funds launched to create supply for this large unmet demand. The number of hedge funds ~4x'd from 1995 – 2005. By 2005, there were ~8,000 funds (LINK).

As a byproduct, many funds also hunted for ideas in niche sectors, in an effort to differentiate from their competitors. In turn, this drove more value-discovery in the obscure corners of the market. Perhaps this factored into small cap's +60% outperformance during this period[8]?

It was (relatively) easy to raise capital, hedge fund managers graced the front cover of business magazines, and a formerly secretive industry stepped into the limelight. This commenced the "mainstream adoption" phase and coincided with the birth of "allocator" as a job description.

The 2008 – 09 financial crisis brought about the "institutionalization" (i.e. maturation) of hedge funds, as the market downturn caused allocators to scrutinize the risk management and operations of these funds to a greater extent. An estimated ~20% of hedge funds closed during these two years alone[9].

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[6] Estimates are there were ~610 hedge funds in 1990 (LINK).

[7] Granted I wasn't around then, but this is what I hear from more tenured investors.

[8] The Russell 2000 was up +71% from 2001 – 2007 (LINK). The S&P 500 was up +11% (LINK).

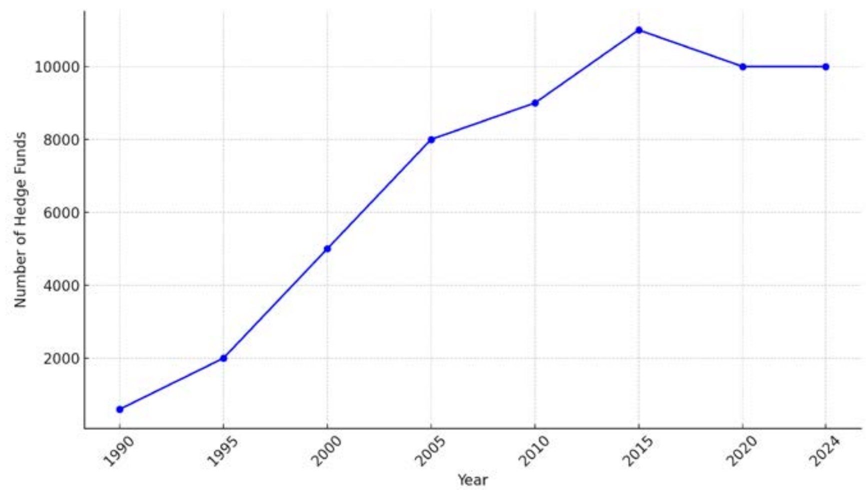
[9] "Hedge Funds Are Closing Like It's 2009" (LINK); "Hedge Funds Took A Serious Hit In 2008" (LINK)

Like in any industry downturn though, it's the survivors that emerge on the other side, that capture the majority of the future spoils. Investors still wanted hedge funds, but were more sophisticated in their evaluation of potential candidates. And these surviving firms were the ones who had the scale / resources to provide the infrastructure and battle-tested track records, that these investors now demanded.

Even though there were still new fund launches keeping the industry total steady, it was the incumbents that garnered a disproportionate percentage of assets. And those funds that did successfully launch, tended to be "spin-outs" from existing firms, which were advantaged by being able to take existing teams, track-records, processes, and even investors with them.

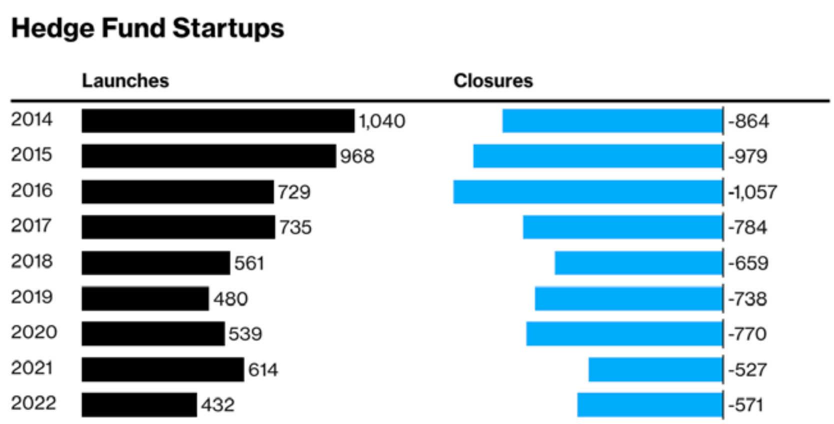
Number of Hedge Funds

From 1990 – 2024



Hedge Fund Launches vs. Closures

Source: Bloomberg, HFR (LINK)



By 2015, we started to see more funds closing than opening. Thus, beginning the industry's "consolidation" phase. According to Hedge Fund Research, there were more closures than launches from 2015 – 2022[10]. Even though the absolute net number isn't large, it's clear that the

[10] We've seen a slight reversal in 2023 and early 2024.

industry is no longer growing as it did two decades ago. During which, industry assets grew from $265 Billion in 2000 to ~$4.5 trillion today – a 17x increase (LINK).

But this alone doesn't explain the change in market structure. What's more important, is also what's happening under the hood:

1) Large hedge funds are garnering a disproportionate amount of industry assets. For instance, hedge funds with over $5 Billion AUM have increased their market share over the years, to now control 73% of industry assets (LINK). Granted, this isn't only happening to hedge funds, but the entire investment industry – mutual funds, ETF providers, venture capitalists, etc. (LINK).

2) And among these hedge fund allocations, the mix is increasingly leaving fundamental, bottoms-up, stock-picking firms towards the trading-oriented, market-neutral, multi-manager firms ("pod shops"). Although these two trends also might just be one large trend, as multi-manager firms are now also among the largest funds in the industry[11].

Since 2017, these multi-manager firms have grown ~9x faster than the rest – at ~18% AUM cagrs vs. ~2% for other strategies (LINK).

There's good reason for this – the multi-manager system is a beautiful one. It gives investors a high single-to-low double-digit annual return, with low volatility and little correlation to other asset classes. And as a business model, it's the only one in our industry that has *benefits* to scale[12]. (If you can't tell, I'm also jealous of their model…)

AUM Growth of Multi-Managers vs. Others

Source: CAIS, Goldman Sachs (LINK)

But while there's nothing inherently "wrong" with multi-managers, their dominance in the last decade has had a profound impact on the market structure for the rest of us boring, old-fashioned, fundamental stock-pickers.

[11] This includes Millennium, Citadel, Balyasny, Point 72, and many others (LINK).

[12] Due to shared technology, fundraising, data resources, back-office support, risk management, etc.

For example, Morgan Stanely and HFRI put these multi-manager firms as collectively managing ~$350 billion in assets (LINK). These strategies rely heavily on leverage for their returns, often to the tune of 3 - 5x of their investors' capital. Including leverage, it's estimated they control ~$1 Trillion of assets, out of the industry's ~$4.5 Trillion, or ~22% of the industry's market share.

At a basic level, the strategy's goal is to earn 3 - 5% per year on an unlevered basis – but hedge out all factor exposures to reduce volatility (i.e. market beta, sector, value / growth, momentum, geography, currency, etc.), so theoretically only "alpha" is left[13]. But then leverage the portfolio 5x to generate 15 - 25% gross levered returns. After fees, this typically gives the investor the aforementioned return profile.

But that's not all… the model is also based on extremely short-duration strategies. How else can you achieve "pure alpha", with little volatility / high Sharpe ratios? It's hard to hedge out all these factors cheaply, over long holding periods. I have many friends who are portfolio managers at these firms, and they describe their jobs as essentially stacking together a handful of ~20 - 50bps days, throughout the year.

Portfolio turnover per year anecdotally ranges from 500 – 1,000% per year (so a $100 portfolio will trade $500 - $1,000 in annual volume). If we apply that to the aforementioned $1 Trillion asset base, we can estimate it's $5 - $10 Trillion in trading volume by the multi-managers per year.

The average hedge fund's turnover is typically ~1/3rd this amount (and mutual funds are ~1/12th)[14]. So if this data / our math is correct, we can see that on a trading volume basis, the multi-manager firms are comprising *more than 50% of trading volume for the entire hedge fund industry*[15].

Is it any wonder why sell-side research shops, who are paid on trading commissions, are increasingly catering to this segment? With majority of the industry's volumes dictated by strategies with a 2-month time horizon or less, is it really a surprise that market dynamics are changing?

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While I lament our changing industry and market structure, complaining really doesn't do any good…

Rather, we must adapt to the way the world *is*, not as we *wish* it to be. So given the above, how can we adapt our investment process to take advantage?

First off, I suspect we need to widen our "hunting grounds" for new ideas - from previously $1 – 5 Billion, to now $1 – 10 Billion market cap. Before 2020, some of our most successful investments were those in the sub-$5 Billion market cap range when we first came across them.

These were companies like Sea Ltd, Carvana, Credit Acceptance, and Afterpay – fast growing companies, that were too small for the majority of the market to pay attention to. And yet given their rapid growth and inflection points in their businesses, their market values grew naturally

[13] Referring mainly to equity pods. Obviously, there's more nuances to this.

[14] Sources cite this at ~100 - 300%, although there's no definitive data available. Mutual funds are ~63% turnover (LINK).

[15] If we assume multi-manager turnover is 750%, and other firms are 200%. Also we assume $1 Trillion AUM for multi-managers, and $3.5 Trillion for other firms. Exact data is hard to come by, but this estimation is likely directionally correct.

from earnings appreciation (not multiple expansion), until they were large enough for other investors to care.

Once that happened, we'd see the stock price accelerate even faster, driven by now multiple expansion on top of growing earnings.

But with multi-manager firms making up more trading volume / becoming the incremental price setters, it means that "tipping point" at which the market cares is higher. It's hard to move ~$30BN in volume per day – so most of these firms require at least $50M - $100M of average daily trading volume, for a particular stock to be "investable"[16].

As a rule of thumb, small-mid cap stocks might trade ~1% of market cap per day as average daily volume, and even lower for large and mega caps[17]. This means for a stock to trade $100M in daily volume, it equates to at least $10 Billion in market value.

If this is true, everything equal, the point at which a well-executing, rapidly growing company captures the market's attention is probably higher than before. Below $10 Billion, we can only count on the earnings growth "engine" to propel the stock, with the second "engine" of multiple expansion only kicking in at a much later stage.

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In a similar vein, I think with the market's shortened time horizon, the payoff curves have changed too. Before, the payoff curves felt linear – with valuations / investor attention rising steadily, in line with a company's growth and value creation. This is especially the case for emerging growth companies.

For example, a new marketplace business might possess all the characteristics that give it a high likelihood of winning vs competitors – a larger supply base, higher daily engagement, high net promoter scores and organic referrals, faster network growth, etc. While the business might still be losing money due to its high fixed costs, given the growth & high incremental margins, all analysis points to likely profitability in 3 years.

Previously, the stock price might rise steadily as the company shows evidence that business plans are on track, and as it gets closer to profitability / business model viability. As margins go from -20% to -10% to breakeven to +10%, valuation multiples would rise steadily as well (corresponding to lower business risk) – resulting in a stock price that rose faster than fundamental growth alone.

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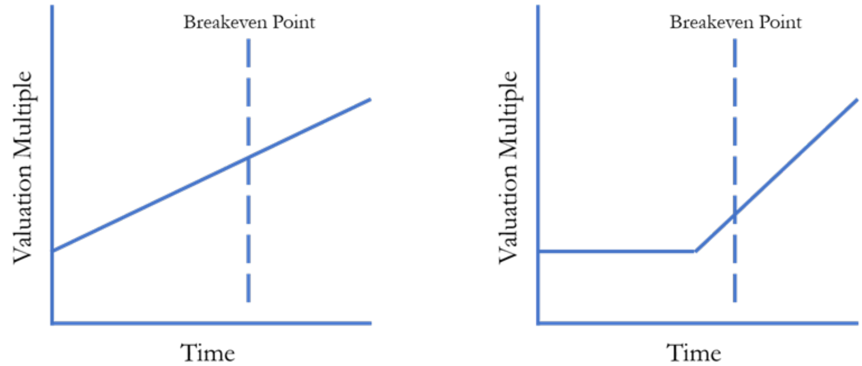
[16] Assumes $7.5 Trillion annual volume / 252 trading days in a year.

[17] Obviously this is just a rough estimate, as volumes can fluctuate based on the particular company or day.

Payoff Curves – Previous vs. Current Market

Illustrative example



However in today's market, it feels like payoff curves are now a "hockey stick" shape. Investors simply aren't willing to under-write early-stage companies over a 3-year time horizon, despite improving financials. Most would instead wait for a few months before the inflection point (for example, when the company breaks-even) to take a position.

The "unproven business model stage" has always been a more volatile period (there's greater competitive threats, fuzzy unit economics, etc.). So in a low-volatility strategy, there's just less appetite to take that risk, even if the payoffs are high. No one wants to give the stock credit, until it's a "proven bet" – then investors rush in all at once, driving up valuations quickly (see the Applovin section below, for a good example of this).

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Contrary to intuition though, these changes in market structure might ultimately be a benefit to Hayden. The market is obviously demanding a higher market cap and level of business model maturity before it's "investable". As such, we can theoretically follow a company for longer and wait for its business model to develop to a later stage, without worrying about other investors driving up the price.

It also means that the equity "yield curve" is steepening. Long-term bets have bigger payoffs than before, since there's less competition for those ideas (so the "cost of capital" for emerging growth companies has increased). We can wait for more "proof" of business momentum / invest closer to the "inflection point". If so, this would mean our new investments should have lower risk at the time of initiation, while paying the same price as before.

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In addition, I've been reflecting on what these industry changes mean for the investment industry over the next decade or two. And more importantly, where Hayden fits in all this.

Back in 2018, I said that Hayden wants to be like a Michelin Starred restaurant with a tasting menu – what you see, is what you get (no substitutions! LINK). Where customers trust the chef to take them on a journey – one that combines their specific expertise and unique viewpoint, to deliver something unanticipated, but delicious. Unlike a diner, we shouldn't try to have 100 different options – each dish palatable, but none of them world-class, just to try to have something for everyone.

I think that statement's more relevant today than ever. If we don't have a clear vision of who we are, and a defined competitive edge, then we'll soon become obsolete.

Almost every maturing industry ends up in bifurcation. The large players are typically a collection of brands (think LVMH, Coca-Cola, Procter & Gamble, etc.) – aiming to have a variety of products, at different price points, to appeal to as many customers as possible. If there's a "hole" in their portfolio, they will buy up and consolidate the industry – utilizing their brand name, financial power, and strong distribution to crowd out competitors.

We're already seeing this play out in the investment industry. In some recent examples, Man Group bought Varagon Capital (~$15BN) last year to expand into private credit, and Australia's Regal Partners is about to buy Platinum Asset Management (~$12BN), in addition to acquiring several specialist firms in the last few years (LINK). We have no desire to compete with these financial "supermarkets", who offer a diverse "menu" in pursuit of greater assets.

Instead, mature, bifurcated industries also have a collection of "craftsmen" type firms on the other end of the spectrum. History has shown there's room for both types of firms (it's the "messy middle", without a clear brand identity, that gets in trouble).

These are the "craftsmen" firms that specialize in one skill / product, and do that one thing very well. They won't be as well known, as wealthy, or have "terminal value" like their conglomerate counterparts.

But through perfecting their craft and doing it at a higher level than their generalist peers, these craftsmen firms are able to find a loyal clientele base. Those who can appreciate the unique products / viewpoints, and the "purity" that only day-after-day focus on a singular technique can bring, undiluted from competing incentives[18].

At Hayden, we should aspire to be like the Japanese or European craftsmen of centuries past - honing our singular craft day-after-day, for the simple joy and beauty of the process itself.

PORTFOLIO REVIEW

Applovin (APP): Applovin's stock has been a major contributor to our portfolio this year. The stock was up +57% during the third quarter alone. And it's appreciated a further +117% so far in the fourth quarter – for a cumulative +240% gain. The stock has risen more in the last 3 months, than the prior 30[19].

When I first laid out our investment rationale last quarter, I certainly didn't expect the stock to re-rate so quickly (LINK). Obviously, intrinsic value didn't change *that* drastically. The business

[18] For example, a firm with multiple products might choose to focus greater resources and time on the more profitable / commercially-appealing one, at the expense of the other products' clients. Or the firm may not invest in a particular security even if the returns are attractive, simply because it inhibits the ability to raise capital from a wider swath of investors.

[19] We originally made the investment in Q2 2022.

didn't suddenly become "higher quality" overnight – the story remains largely the same as when we first bought it 2.5 years ago. (But perhaps this is further evidence of the "hockey stick" payoff / change in market structure discussed above).

Nonetheless, I'm writing about Applovin again this quarter, simply because I think it's an interesting case study in how the market's *perception* around its earnings quality and durability of growth can drive rapid price changes.

I mainly write this for myself as reference, in anticipation of similar scenarios in the future. And also as an effort to improve our investment process (which hopefully our partners will gain a better understanding of too).

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So why the market's sudden appreciation for this business? I believe the primary catalysts came during the last two earnings calls.

On the Q2 2024 earnings call, Adam Foroughi (Applovin's Founder & CEO) reiterated his belief in the company's 20% - 30% long-term growth trajectory. Adam had said this before, but investors had largely glossed over it before as a "throwaway" comment.

This quarter was different though, as Adam provided detailed steps of how he reached this conclusion (and the financial results started showing evidence to back this up):

"Last quarter, I talked about a goal of growing our software business 20% to 30% for the long term. I typically don't communicate externally about our goals, if I don't have confidence in it. I'm communicating it now because I do have strong confidence in it, and I see many years of growth ahead of us." (LINK)

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The Path to 20% y/y Growth

When asked about this later on the call, he explained:

*"**[the goal is not] very dependent outside of gaming at all**… We've got a mobile gaming category. It's got a few percentage points of growth a year now. So let's call that low single digits. We've got a business that as these models continue to improve from gathering more data, we think that's an extra 3%, 4% a quarter as well. So that's where it gets you to the low end."*

Translation: Applovin thinks it can easily hit the low-end of guidance (20% y/y growth), simply from a couple percent per year of industry growth + self-improving models that allow them to grow an additional 12 - 17% per year on top (3 - 4% per quarter).

Adam's making the point that simply due to the nature of artificial intelligence / machine learning models, their algorithms *naturally* get better *by itself* as it ingests more data. Even if no human engineer ever touches it again (i.e. it's the same "version", but with more data).

So the majority of the low-end guidance is based on "organic" growth – i.e. something that will occur in a predictable way, and essentially "guaranteed" in Adam's view[20]. And at *zero* incremental costs, to boot.

The market tends to reward predictability and self-determined growth (and more so if it's 100% incremental margins), so this comment naturally allowed the market to bid up the valuation multiple.

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Going From 20% -> 30% y/y Growth

Next, he stated:

"And then we've got a team that's constantly working on improving the models. And ***any improvement that's actually developer-driven enhancement to the models that makes them more accurate, then steps you up into the higher end of that range****. And so we've got a lot of confidence in the growth goal we put out there just on a baseline basis, the current business."*

Translation: If Applovin's engineers do make manual improvements to the algorithm (beyond simply feeding it with more data), this will create "step-function" improvements in the model accuracy (and ultimately in financial returns).

The most obvious example of this is the upgrade from Axon 1 to Axon 2 in early 2023, which created a +140% increase in the ads business in just two years[21]. These returns are "lumpy" since new model versions are only launched periodically. More importantly though, this component of growth is also within the company's control, rather than at the whims of the industry or macro environment.

This statement further solidified the market's confidence that the company's growth guidance is *structural / self-determined*. Since it's based on improvements in the algorithm (i.e. the ingenuity of Applovin's engineers), the company's future is more firmly in its own control than the market had appreciated.

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The Call Option: Getting to >30% y/y Growth

Lastly, Adam gave investors a "call-option" on top of this already impressive guidance:

"Now we do, do sit on 1 billion-plus daily active users. We've got one of the most sophisticated advertising platforms in the world, and we're driving billions of dollars of performance value in gaming. There's nothing about the technology we have that would disallow it from ***going outside of just mobile gaming, and we're already seeing positive trends in that pilot.*** *So as we start putting these pieces together and broaden out our platform over time, we're really excited about how big the numbers could become."*

[20] I use this term with extreme caution. Nothing is ever guaranteed.

[21] See our Q2 2024 letter for more details; LINK.

"So we're not backing those numbers into longer-term views on the business. So we think we're going to be - in a place where this business is going to be steady, it's going to be growing at a very nice rate. ***The conversion to cash flow is only going to improve, and we've got a lot of other exciting things that are going on that give us confidence that we could even be above those ranges."***

Translation: On top of the previous guidance, Applovin plans to expand into ecommerce performance ads. This is still in the early phases, so it's not incorporated to the previous guidance at all. But if it works, it could expand Applovin's addressable market by 2 - 4x, and result in over 30% y/y growth.

And then on the following Q3 2024 earnings call, investors started getting concrete data points on this call option.

"While we remain confident in 20% to 30% growth for mobile gaming advertisers alone, we're also exploring new areas, as shown by our recent e-commerce pilot. ***Early data has exceeded our expectations, with the advertisers in the pilot seeing substantial returns, often surpassing those from other media channels*** *and, in many cases, experiencing nearly 100% incrementality from our traffic."*

"We're increasingly confident this vertical will scale significantly in 2025 and become a strong contributor for us over the next year and beyond… *In the next few quarters, we'll launch a self-service platform, opening global opportunities for advertisers of all sizes."*

"In all my years, it's the best product I've ever seen released by us, fastest growing, but it's still in pilot."

"We're not going to invest heavily in sales, and we're going to organically grow over the years. And we've done that.

And you can look at the trajectory of the company since we've been public, but even if you backdate it to when we started, every year, we've gotten bigger and gotten more penetration into the gaming category and done it organically. ***So when we look at e-commerce, we're not in any sort of rush. Now that said, if you check even Twitter today, there's tons of noise from e-commerce brands saying, in our pilot, they're seeing as much scale and a strong ROAS as they're seeing anywhere in the world today on their user acquisition buys."*** *(LINK)*

Translation: Despite being launched just a few months ago, both Applovin and early customers are already expressing extremely positive reviews of the product. The call option "dream" started becoming "reality" in investors' minds.

Not only is the new initiative doing well, but Applovin believes that they can scale the business in a similarly cost effective manner as the core gaming advertising business.

This removed a major point of uncertainty for investors. The market previously feared that Applovin would need to invest heavily into the ecommerce business (via both data-purchases and hiring sales personnel), thus depressing margins & profits in the near-term. This quarter's earnings call quashed that fear.

The street is now modeling for the ecommerce division's unit economics to be just as attractive as the core gaming advertising business. This means that near-to-medium term margin expectations are rising, and therefore further expands the valuation multiple.

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Reading the above comments, it's easy to see why investors are excited about the story.

Over the last two years, Applovin has gone from being valued as a commoditized ad network with low switching costs, to one that owns ~30% of the total gaming market and is instrumental in the monetization of the entire mobile gaming ecosystem.

Now, the market is finally recognizing the heart of this business is in the algorithm itself, which can be expanded to other verticals like ecommerce.

What's interesting though, is that during this time period, the company's expected financial trajectory has largely stayed the same. For example, sell-side estimates actually haven't changed much in the last two years.

When we first invested in early 2022, the street was expecting Applovin's EBITDA to be ~$1.8BN in 2024 and ~$2.1BN in 2025. Two and a half years later, the street is now looking for ~$2.6BN EBITDA in 2024, ~$3.4BN in 2025, and ~$4.1BN in 2026.

The +44% and +62% increase in 2024 and 2025 estimates are nothing to sneeze at. But it's certainly not enough to justify how much the stock rose at the same time.

Rather, most of the stock's gains have come from multiple expansion. Multiples have risen from ~8x EV / EBITDA (2yr forward), to ~24x EV / EBITDA (2yr forward). Given the above, we can calculate that ~70% of the total stock return is from multiple expansion, with ~20% attributed to EBITDA growth, and the remainder to Applovin's share buybacks over the period[22].

Applovin's perceived "quality of earnings" improved from one that's majority transactions / low quality gaming revenues, to one that comes from a repeatable and superior advertising engine. The market now has visibility for a 10-year runway for this company, rather than just a year or two out. Multiple expansion is really what's created a 7-bagger for us in the last few years.

So the lesson is, focus on not just earnings growth, but also the quality of that earnings stream and the durability /"predictability" of it. If you can get both right, that's where the real winners are (I wrote about this in our "10-Bagger Club" piece a few years ago too; LINK).

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So what are we doing with the stock now?

Well, the driver of future returns have shifted from the gaming ad network, to now getting the ecommerce extension right. Essentially, it feels like the gaming ad business's growth potential is fully priced-in. Future returns require a successful ecommerce ad product, and gaining material market share in the next few years.

Due to this higher hurdle, we've been trimming the stock along the way and have now recouped ~2x our original cost basis. Yet, it's still one of our largest positions. In relation to Hayden's

[22] Applovin's valuation multiple has expanded ~200%, while EBITDA has grown ~127%.

portfolio, the stock is up ~7.6x since we first began buying 2.5 years ago, and an astonishing ~31x from its December 2022 lows[23].

We continue to follow the company closely, and are watching if they can successfully transition to their next leg of growth. So far, early signs are pointing to "yes".

CONCLUSION

It's been a hectic few months of traveling. I just returned from a three week trip in Southeast Asia (Indonesia, Philippines, Singapore, and Australia), and am heading to China in a couple weeks.

In January, I'll be in Switzerland for my friend Rob Vinall's conference in Engelberg (with a stop in Zurich), and then it's off to London the following week. Afterwards, it's another trip to New York.

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A lot has happened in the last few years – both for Hayden and personally. Sometimes I feel like we're always so focused on our day-to-day lives, plodding along, trying to get better at our craft – that we also forget to pop our heads up to see just how far we've come and take stock of what's truly important in life.

That's why I'm looking forward to this holiday season. It's been a busy year, and I anticipate 2025 will be just as packed. It's rare that we get time to slow down just to reflect, catch up on reading, and just spend the little moments with family.

I wish our partners a great holiday season. And look forward to seeing you somewhere in the world, in the New Year.

As always, please shoot me an email if you're in any of these above locations, and would like to meet up.

Sincerely,

Fred Liu, CFA
Managing Partner
fred.liu@haydencapital.com

[23] Our original purchases were at ~$38 per share. The stock reached $9.14 in December 2022.

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