Ennismore Global Equity Fund

Investor Newsletter for the month of June 2020

Issued on 9 July 2020

Fund Details

Daily dealing UCITS and Irish Central Bank regulated open-ended investment company with Financial Conduct Authority recognition and registered in Ireland. The Fund size was USD 459m as at 30th June. Total assets under management by Ennismore Fund Management were USD 966m. The fund closed to new investment at the end of 2019. Please contact Jo-Anne Bailey on +44 (0) 20 7368 4231 or email subs@ennismorefunds.com if you would like more information. Redemptions can be made through the Administrator in the usual way.

Top Five Long Holdings as at 30 June 2020

	Company	Country	Sector	% of NAV
1	Vivendi SA	France	Communication Services	5.5
2	Royal Mail PLC	United Kingdom	Industrials	5.3
3	Electronic Arts Inc	United States	Communication Services	5.2
4	Schibsted ASA	Norway	Communication Services	5.0
5	Fevertree Drinks PLC	United Kingdom	Consumer Staples	4.8
				25.8

Exposures as at 30 June 2020

Longs %	Shorts %	Gross Exposure %	Net Exposure %
82.3 (80.1)	79.4 (73.9)	161.7 (154.0)	2.9 (6.2)

Figures in brackets refer to previous month end. All exposures are calculated on a delta adjusted basis.

Exposures by Country, Market Cap & Sector as % NAV and Positions as at 30 June 2020

Country	Gross%	Net%
United States	59.2	-15.8
Germany	22.2	5.4
United Kingdom	22.4	9.3
Cayman Islands	8.2	-8.2
Norway	8.1	1.9
France	6.1	5.3
Netherlands	5.9	5.9
South Africa	5.0	3.7
Australia	4.7	-4.7
Japan	3.5	1.3
Luxembourg	3.3	2.7
Other	13.1	-3.9

Market Cap	Gross%	Net%
>$10bn	72.0	1.2
$5bn-$10bn	19.1	-2.6
$1bn-$5bn	58.4	11.1
<$1bn	12.2	-6.8

Positions	Jun	May
Long	46	49
Opened	2	4
Closed	5	6
Short	100	98
Opened	10	9
Closed	8	6

Sector	Gross%	Net%
Communication Services	44.0	13.8
Consumer Discretionary	36.1	1.8
Consumer Staples	11.4	10.5
Energy	0.0	0.0
Financials	9.2	1.9
Health Care	10.3	-0.2
Industrials	18.1	-3.4
Information Technology	24.7	-21.3
Materials	4.3	1.5
Real Estate	3.2	-1.3
Utilities	0.0	0.0
Other	0.4	-0.4

Geographic analysis relates to country of incorporation or listing. This may not represent the underlying economic exposure of the operating business.

Performance as at 30 June 2020

	Share Class					
	GBP	GBP A	EUR	CHF	EUR I	USD I
NAV per share[1]	**12.23**	**12.16**	**11.68**	**11.39**	**9.82**	**9.66**
Period	**% Change**					
June 20	**2.3**	**2.2**	**1.2**	**0.8**	**2.1**	**2.1**
May 20	-1.0	-0.9	-4.5	-3.4	-1.1	-0.9
April 20	4.7	4.6	6.6	6.2	4.6	4.7
2020 to date	**-10.9**	**-10.9**	**-16.9**	**-18.6**	**-11.6**	**-10.8**
Annualised return[2]	**5.5**	**5.4**	**4.2**	**3.5**	**-0.9**	**-2.3**
Since launch[2]	**22.3**	**21.6**	**16.8**	**13.9**	**-1.8**	**-3.4**
	Discrete 12 Month Rolling Performance					
To 30 June 20	**-9.8**	**-10.1**	**-12.1**	**-15.4**	**-11.4**	**-10.9**
To 30 June 19	**11.9**	**11.8**	**10.8**	**7.0**	**-**	**-**
To 30 June 18	**20.7**	**20.7**	**20.6**	**25.9**	**-**	**-**

[1]Source: Administrator, Net Asset Value. [2]Since inception of GBP, GBP A, EUR and CHF share classes on 03/10/16, EUR I share class on 03/07/18, USD I share class on 02/01/19. Note: All performance figures net of fees. **Past performance is not a guide to future returns.**

Attribution %		GBP	EUR	CHF
Long	Q2 20	25.2	23.5	23.5
	Q1 20	-23.8	-25.6	-27.0
	Q4 19	-1.0	3.3	3.0
	Q3 19	4.2	5.2	3.4
Short	Q2 20	-18.9	-18.7	-18.7
	Q1 20	7.7	7.0	6.9
	Q4 19	-2.2	-2.5	-2.5
	Q3 19	2.8	2.7	2.8

Attribution figures exclude cash returns and are prior to expenses

Top 5 Contributors and Detractors for June 2020

Contributors	MTD (bp)
Wirecard AG	356
Vivendi SA	58
Naspers Limited	48
Under Armour Inc	42
Enphase Energy Inc	40

Detractors	MTD (bp)
Tencent Holdings Limited	-110
Australian financial services company	-81
Tesla Motors Inc	-81
US energy company	-63
US technology company	-55

Individual stock attributions relate to GBP A shares and are gross of fees and expenses (including financing/stock borrowing costs).

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The fund's NAV increased by between 3.1% and 6.0% in the quarter, depending on currency.

The largest contributors from our long positions were Etsy Inc. (2.8%), a position in tonic maker Fevertree Drinks PLC that we built up in March (2.4%) and Royal Mail PLC (2.0%), which we have written on later in this letter. With equity markets rallying almost as quickly as they fell late in the first quarter, there were not many negatives on this side of the book. The only one worth mentioning was Rolls-Royce Holdings PLC (costing 0.4%). We sold our remaining position as the time horizon for air passenger volumes to return to even close to pre-crisis levels looks a lot longer than we expected last time we wrote to you.

The short book was inevitably costly in the quarter. On the positive side our long running short in Wirecard AG finally paid off, contributing 3.7% to NAV. We share a few thoughts on this one later. But there were a number of expensive positions too, notably an Australian financial services company (costing 2.4%) and Tesla Inc. (1.9%). Both have business models that are unprofitable. We don't think that can change because it seems to be a feature, not a bug.

The fund's net exposure decreased markedly over the quarter. In part this came from selling long positions that had reached our estimate of fair value (like Etsy Inc.), and in part from adding new short positions based on a combination of business models with chronic cash burn and an economy with what may prove to be the worst unemployment since the Great Depression. Overall the contrast between the outlook for jobs, consumption and (ultimately) company earnings and recent equity market returns seems as dramatic as we can ever remember (and yes, we were in business through both the dotcom bubble and the financial crisis).

"Stayed neither by snow nor rain nor heat nor darkness from accomplishing their appointed course with all speed"

We are not activist investors but we do sometimes try to engage constructively with management, where we think a change in strategy is achievable and will help deliver value. We took a position in Royal Mail PLC ("the Group") late last year because we believe that is the case. It is essentially two separate business – Global Logistics Systems BV ("GLS"), an express parcel company operating mostly in the EU, and the Royal Mail, the postal service in the UK (its Parcelforce business fits operationally with GLS but can't be separated from the UK business for reasons that will become apparent). Our simple thesis is that the two businesses do not benefit from being under the same roof (the company itself states "there are few synergies between Royal Mail and GLS") and, in fact, we think that keeping things this way may destroy value over the next couple of years because it will make a much-needed restructuring of Royal Mail less likely. Management is now clearly thinking about the two businesses as separated, with a CEO for each reporting to the Board. They need to follow through and make the divorce final.

GLS provides a network for collecting and sorting parcels, with last mile delivery outsourced to subcontractors. This is a high return, relatively asset light business. Based on subsidiary filings we estimate that it generates a return on capital of around 30%, before tax. It is growing steadily (and mostly organically) as the need to send parcels increases. Over the last 5 years volume shipped across the system increased at a compound growth rate of 11%, with revenue up a little faster. Operating margins have been pretty stable at around 7%. This is a competitive industry where scale matters, and GLS has achieved it in most of Europe. We think a valuation of 10 to 15 times operating profit is reasonable - roughly GBP 2.1-3.2bn.

The Group as a whole is currently valued by the market at GBP 2bn. It has no net debt, its pension liabilities are limited and very well-funded and it is selling excess land that will bring in maybe another GBP 200m. In other words, on our estimates, the implied valuation of the Royal Mail is negative to the tune of at least several hundred million pounds. What is so bad about this business? After all, when the company was privatised in 2013 it made about GBP 300m in operating profit a year. True it will lose money this year, and would have even without the excess costs associated with social distancing, but is it really worth less than nothing?

The simple answer is that, for shareholders, it shouldn't be. There is nothing preventing a spin-off of GLS. We would then own two separate listed companies. If Royal Mail is really worthless then the upside on the combined holdings would be somewhere between 5 and 60%. But we don't believe that it is. In fact, we think it will be worth more alone. The profit it makes in the UK (outside of Parcelforce) is regulated by Ofcom. In return Royal Mail delivers the universal service obligation ("USO") – basically a commitment to deliver letters to your door 6 days a week, and parcels 5 days, no matter where you live. There is no mandated return but the regulator has talked about a 5 to 10% margin as being sustainable in the past. As Royal Mail is currently losing money the regular 10-year review of the USO has been brought forward to 2020. It needs radical change – letter volumes are not coming back – but oddly Ofcom's remit is partly to assess its sustainability based on the cashflow profile of the whole group. That is, it is less likely to reform the USO as much as it needs to while GLS is under the same roof. Spinning off GLS is the right thing to do for shareholders. It is also, in the long run, the right thing for UK consumers if they want a sustainable postal service that looks anything like the one they are used to (or the ancient Persian one that Herodotus was describing in the above quote). That will also need labour unions (which unfortunately cover Parcelforce in the same agreements as Royal Mail) to recognise that, as more and more of the volume mix shifts from letters to parcels, the market will only become more competitive. The current cost structure cannot survive.

Getting the Royal Mail to make money again won't be easy. There will likely be a lot of compromises all round and its historic profitability will probably stay as just that, a part of history. But even a very low return on capital would imply GBP 100m or more of annual profit, and another 50% upside to the share price. Combined with the much safer value we see in GLS we think Royal Mail PLC shares are a great value investment, particularly if management continues down the path it seems to have started.

"He replied to one that gave him joy of his victory, that one other such would utterly undo him""

Plutarch put those words in the mouth of Pyrrhus of Epirus. We can sympathise but our risk management process is designed to make sure we never have to feel the same way. A little over six years ago we believed we had documented a black hole worth hundreds of millions of euros in a company's accounts. This was based only on the published financial statements of the company and of its subsidiaries. The information was available to anyone else who looked - the company's Board, investors, auditors, regulators, basically anyone who read the financial statements. But the suggestion that there were problems with this company was dismissed by them for years. Shareholders who made money taking long positions in its shares got lucky.

On the 18th June this year the company, Wirecard AG, finally admitted that nearly EUR 2bn of cash was missing (in the real world it wasn't missing, it was a work of fiction in the first place). We think its shares are worthless today. But then that has always been true, even though the price they traded for increased more than fivefold in the meantime. That ride means that although the fund's short position has made money overall that will not be true for all of our clients. We did not have much luck with it. We are sorry that that is the case but, as we explained in our June 2018 letter, our focus is on getting our analysis right because that is something we can repeat. And over time - and a large number of positions - luck will even out. We have a feeling the next few years might be a little kinder to shorts like this one.

Which brings us nicely back to classical history. In 279 BC the Greek King Pyrrhus won (we are going with Hieronymus's version) the battle of Asculum. The defeated Romans lost almost twice as many men and were forced to retreat. But the battle is remembered (or perhaps misrepresented) because the Greek losses were too heavy to allow them to continue their campaign on the Italian mainland. They won the battle but lost the war.

We think there is an appropriate analogy here with risk management. A really large short in this company would, left open, have done so much damage to the fund's performance it is possible it would not have survived to see it blow up. That is why we always apply strict limits to individual short position exposures (something we discussed in our February newsletter). There is an opportunity cost to this, of course. It limits how much money we make when a company we are short does collapse, especially when it happens quickly (and it often does). But rules need to work in the worst case scenario, not just the best.

"A man is known by the company he keeps"

We have steadily increased the number of individual shorts in the Fund since it started. One of the reasons we are happy managing a lot more of these positions today is that we have become more systematic in our approach to finding them. For example, we have an ever-growing database that looks for patterns in the behaviour of people involved with a company – management, shareholders and their associates, of course, but also those involved less directly (like bankers, auditors, lawyers, PR firms and so on). Following these threads sometimes leads us to companies that we want to short, at the right time. We'd like to run you through one of those now.

The personal webpage of the CEO of the company we have in mind starts with a banner asserting that he has been dubbed the "Zelig of Wall Street". Zelig, for those who don't recognise the reference, is a 1983 Woody Allen movie set in the interwar period, about a non-descript man who transforms his appearance to blend in with the people around him. In the film the character keeps turning up at key events of the time, from a party with F. Scott Fitzgerald in the roaring twenties to Depression-era Nazi Germany, and that's the comparison we think the reference was making.

The eighties

Our real life Zelig features in a different period, the era of financial deregulation that began in the 1980s. In 1985 he was hired by the American investment bank Drexel Burnham Lambert Inc. ("Drexel"). At the time it was one of the most powerful forces in US capital markets because of its almost unparalleled ability to raise money to fund acquisitions, backed by its dominant junk bond sales team in Beverly Hills (a few captive savings and loans clients helped too).

Drexel's junk bond operations were led by Michael Milken. In 1990, at the end of a long chain of legal and regulatory actions that began in early 1986, Milken pled guilty to six felony charges of securities fraud and conspiracy and agreed to pay USD 600m in fines and penalties. He was later sentenced to 10 years in prison (Drexel had already collapsed into bankruptcy after settling with the Department of Justice and SEC). A key witness was our Zelig, who had sat to the left of Milken on Drexel's infamous X-shaped trading desk in Beverly Hills. Milken had hired this young salesman to handle only one account, Solomon Asset Management and the related junk bond mutual fund, the Finsbury Fund ("Finsbury"). Drexel and Finsbury conspired to inflate bond prices paid by the fund, to funnel extra commission to Milken, and to generate phony tax losses for its principal. Records of these transactions were kept in a blue ledger book by the salesman. In return for immunity from prosecution he testified that Milken had instructed him to get rid of the book and detailed the entire scheme with Solomon, which was one of the six felonies Milken pled guilty to in 1990. Milken himself was pardoned by Donald Trump this year.

The nineties

In 1993 the SEC charged the receivables factoring business Towers Financial Corporation ("Towers"), alleging it had operated a USD 500m Ponzi scheme, one of the largest in US history. The case was recently in the news again because its principal, Steven Hoffenberg, claimed that Jeffrey Epstein was his co-conspirator in the fraud. Few assets were recovered from the collapsed firm, but about USD 20m in cash and a similar amount of receivables were injected into a new entity, Qualis Care LP ("Qualis"), in the hope that it would be able to collect more for creditors than a liquidation. Qualis was a joint venture with an entity controlled by John Hall, who proceeded to systematically strip it of its assets. The resulting lawsuit brought by creditors alleged that a certain former salesman at Drexel sold Qualis nearly worthless securities for USD 10m, with Hall (who pled guilty) the ultimate beneficiary. We believe the case against our Zelig was dismissed.

The noughties

Between May and October 1996 Michael Wachs sold 3 DC-8s, 485 railroad cars and 338 barges for about USD 26.1m. The only problem was the assets weren't his to sell, they belonged to his employer Chase Manhattan Corporation. Wachs went to prison and was barred from the banking and brokerage industries.

Wachs re-appeared in the early 2000s running CEOcast, Inc. ("CEOcast"), a website that promoted penny stocks. One of these was Hythiam, Inc. ("Hythiam"), which was marketing a treatment for methamphetamine addiction branded Prometa. There had been no controlled study of the product and, because it was just a cocktail of existing off-label prescription drugs, it didn't need FDA approval. Hythiam's CEO said he felt compelled to improve addiction treatment after seeing his half-brother struggle with cocaine and alcohol dependence and his company made big claims about Prometa's effectiveness. The problem was it didn't really work. Double blind tests showed no benefit compared to a placebo. Hythiam's CEO was, of course, our Drexel salesman again.

The teens?

By around 2010 the relationship between the two had deepened, with Wachs becoming a partner in the Hythiam CEO's venture capital firm Socius Capital Group, LLC ("Socius"). CEOcast continued operating as a related entity. Also working for both firms was Richard Josephburg, who had been jailed for tax evasion in 2007 (he was jailed again in 2019, this time apparently relating to his work for CEOcast and Socius). In May and July 2012 Socius used Halcyon Cabot Partners, Ltd. ("Halcyon"), a broker-dealer employing Josephburg's son, to conceal kick-backs from investments it made in shares and warrants of biotech company Cell Therapeutics, Inc. The Financial Industry Regulatory Authority barred Halcyon and Josephburg junior as a result. Cell Therapeutics, Inc. shares have since lost almost all of their value.

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Socius (later known as Crede Capital Group, LLC) provided new capital for and invested in dozens of other penny stocks over the last ten years. Many have little or no value today. One recent example was part of what can most charitably be described as a blockchain promotion. On December 20th 2017 Net Element, Inc. ("Net Element") announced a partnership with Bunker Capital to develop and deploy blockchain solutions. Its shares went from a price of a little over five dollars to nearly twenty the same day. After some probing from the SEC about what these solutions would actually entail, the relationship was terminated two months later on 26th February 2018 (although this wasn't disclosed until 6th March).

The twenties (again)

There is something mystical about financial markets' ability to forgive. An article from the late 1990s describing our man's exit from biotech Hollis-Eden Pharmaceuticals (he had evangelised a treatment for AIDS it was developing, which of course never came) concludes:

> "He hints at big upcoming deals that will redeem his career, much as Global Crossing has reinvented Gary Winnick, another former Drexelite granted immunity from prosecution in the Milken case."

Global Crossing filed for bankruptcy in January 2002 (in the end it didn't exactly salvage Winnick's reputation, although it did make him rich) but our man is still promising redemption, and some investors are still buying it. That is good news for us. It is why this method of sourcing short ideas can work so well.

When the Prometa story failed Hythiam changed its name to Catasys, Inc. and then, just this week, to Ontrak, Inc. ("Ontrak"). Today it describes itself as "a leading AI and technology-enabled healthcare company", with a software platform that can predict when patients will stop taking medication and help save insurers money. It has tangible fixed assets worth less than USD 200,000 and burned through about twenty million dollars in the last year, on USD 40m of sales (even while paying USD 6.5m of salaries in stock and USD 3.6m of interest in kind). To keep going it placed USD 35m of loan notes through Goldman Sachs' Specialty Lending Group in September 2019. That debt is the kicker that makes Ontrak a really compelling short today.

The money didn't come cheap (the annual rate expensed in Q1 20 was 15.75%), or easy. And we don't think it bought much time. The related covenants are so tight that we expect the business will default this year or early next (in fact they were already amended at the end of June, presumably because the company was in breach). For example, trailing 12 month consolidated adjusted EBITDA needs to be better than a USD 7.75m loss by the end of December (extended from September) and that hurdle increases in steps to USD 20m adjusted EBITDA profit by the end of 2021 (the previous covenant was USD 20m by the end H1 21). This had meant that, to avoid defaulting, Ontrak needed to be breakeven on this basis over the next six months (something it has never managed), and then to rapidly become highly profitable. It now has a little more time, but we think the outcome is the same. Other covenants are just as tough. Revenue was required to come in above USD 22.6m in Q2 (we guess that is one of the covenants they breached). It now needs to average USD 18.75m over Q2 and Q3 (the company reported sales of USD 12.3m in Q1, up a little on USD 11.8m in the previous quarter). Ontrak could deliver on all that, but we are backing our man, the former Drexel salesman and current Ontrak CEO Terren S Peizer, not to come through for other investors once again.

"Others live to eat, myself I eat to live"

Just Eat Takeaway.com N.V. ("JET", formerly Takeaway.com) operates websites which allow consumers to order food online for delivery either by the restaurant (the marketplace model) or by JET's couriers (the logistics model). JET takes payment for the order, usually via the app, and a commission of 12-15% for a marketplace order (more for a logistics one, to cover the cost of the courier). The business aggregates consumers for restaurants, driving demand more efficiently than they would be able to alone, and aggregates restaurants for consumers, making it easy to place an order somewhere that is open and can deliver the food they want. CEO Jitse Groen founded the company in the Netherlands as a student in 2000, with (perhaps apocryphally) fifty euros of capital. He plugged away for twelve years before raising external funds, eventually taking it public in 2016. We bought a position in the company in 2018.

A tasty business

For many years food delivery websites were pure marketplaces. With this business model, growth came from displacing phone orders for restaurants that already did delivery. The economic characteristics of the dominant marketplace business were wonderful. They enjoyed significant scale economies – more orders leverage fixed costs and broader geographic coverage makes advertising spend more effective. Pretty much the only marginal cost of an additional order is processing a card payment. The site with the largest consumer base is obviously most attractive to restaurants, and breadth of restaurant supply reinforces the advantage in attracting new consumers and results in higher conversion rates from visits to orders, in a virtuous circle. Finally, customers are sticky. Ordering takeaway food is a habitual activity, and a platform which aggregates all of the restaurants in an area leaves consumers in that area with no reason to try another site. Takeaway.com's Dutch business demonstrates the returns a dominant business can achieve, with a 63% EBITDA margin (and very little capital investment) by 2015.

A year ago the investment thesis for Takeaway.com seemed simple: the business looked to have completed its strategic journey by establishing dominant positions across much of northern and central continental Europe, after Delivery Hero SE conceded defeat and sold out to it in Germany. It was poised to reap large profits as rapid order growth continued at high incremental margins, without any need for increased marketing spend given the existing ubiquity of the brands in its major markets. German margins would trend up, and market penetration there was so low that high growth seemed to be locked in for many years to come. We viewed the risk-reward as highly attractive, particularly because of the defensibility of Takeaway's remarkably strong competitive position in its core Dutch and German markets. Within the prevailing business perimeter, we saw a relatively narrow range of outcomes, heavily skewed to the upside.

Today things are different. It turns out the strategic ambitions of Jitse Groen were larger than dominating northern European food delivery. Takeaway.com completed the all-share acquisition of Just Eat PLC ("Just Eat") in January 2020 (making it JET) after a bidding war with Naspers Limited, and in June announced another all-share agreement to acquire Grubhub Inc. ("Grubhub"), a longstanding US peer. A year ago the company's addressable market was c.165m adults, almost all in continental Europe. If the Grubhub deal completes on the proposed terms (creating "Grubjet"?), the resulting group will have an addressable market of almost 1bn adults across four continents and will have increased its share count almost three and a half times. The economic character of the group will have fundamentally changed too. The proportion of revenue derived from markets where it has >90% market share (of orders made through aggregators) will have declined from c.80% to less than 20%. The foreseeable range of outcomes for this business is wider than it was a year ago. But the valuation has fallen a lot, and the business has a larger exposure to markets with arguably more growth potential. So today we have a higher risk investment, but with potentially higher rewards. Here we examine some of those risks and try to assess how things might play out.

Fat margins and a diet

The high profitability of the marketplace model inevitably attracted attention. Direct competition against a dominant incumbent is tough because consumers have no real incentive to switch. Instead, beginning in 2012, new entrants tried to disrupt the market by providing the logistics to deliver orders, as well a platform to make them. Skip The Dishes launched in Canada in 2012, Deliveroo (in the UK) and Doordash (in the US) in 2013, and Uber Eats in 2014. This opened up supply from restaurants that hadn't previously delivered, notably the quick service restaurant ("QSR") chains, providing a unique selling point compared to the established marketplaces. The logistics players could also offer a more consistent delivery experience with more granular information, including the ability to track the courier's progress on the app.

The snag is the unit economics. Even if a courier can manage two deliveries in an hour, that is a lot of cost to cover from a typical EUR 20 food order (outside of China, where Meituan's top couriers in big cities reportedly manage up to 50 orders in 15-hour days, there is little evidence of couriers averaging much more than that). In Germany or the Netherlands, where hourly all-in labour costs for minimum wage employees are not far off EUR 15, it is probably never going to be profitable. In the US, where comparable costs are a third lower, it may just be (for now). On top of that the logistics are tough to manage. It requires balancing courier supply against the rush of orders in narrow evening peaks, particularly at weekends. And tensions amongst different stakeholders are obvious: maximising courier utilisation (to reduce delivery cost) competes with the need to have available couriers to minimise consumer waiting times. Platforms can shrink delivery areas to improve efficiency and cut consumer wait times, but this damages restaurant selection for the consumer, and constrains addressable market for the restaurant.

With those unit economics the logistics business model requires substantial funding to scale. But funding has not been in short supply and so scale they did. The logic was apparently that huge order volume would somehow bring down delivery costs enough and that, once built, the logistics network could find other valuable (but as yet largely undefined) uses. Managers of highly profitable incumbent marketplaces like Takeaway.com faced a dilemma: staying put risked compromising the positive network effect they were built on, because they couldn't offer restaurants that didn't have their own delivery drivers. But moving into offering logistics would mean embracing a big cut in margins, a significant increase in business complexity and risk alienating restaurants already on their platforms.

Choosing to stick to a profit diet isn't easy, particularly under the scrutiny of public markets. It may not be a coincidence that the two major food delivery businesses that navigated the dilemma best (Takeaway.com, Delivery Hero SE) were still private at the time, while those which mis-stepped (Just Eat and Grubhub, Takeaway's acquisition targets) were already in the public glare. It's true that Takeaway.com faced a less threatening competitive environment: its core continental European markets offer particularly unfavourable unit economics for logistics owing to tight labour regulations (constraining the gig economy), relatively high costs of unskilled labour, and lack of a tipping culture. That meant they were not the first to see aggressive entry by venture capital funded competition. But Takeaway.com's management still responded relatively early, launching its own logistics operation in 2016, helping to neuter the threat. Just Eat, by contrast, saw aggressive investment by Deliveroo in the UK from 2015, and didn't retaliate with its own logistics effort until 2018, by which time Deliveroo and Uber Eats had built substantial businesses. That strategic misstep led to its acquisition by Takeaway.com this year.

Indigestion?

With Just Eat, Takeaway.com acquired a collection of largely marketplace model businesses, most in leading but not dominant positions in their respective markets. Combined these took orders for over GBP5bn of food (known as "GMV") in 2019. Although a lack of investment in logistics had allowed competitors to take significant market shares (of revenues, if not profits) Just Eat still grew orders by 15% in 2019, and revenues by almost 30%, and generated about GBP 200m EBITDA. Takeaway.com effectively paid GBP 5bn to buy it (after adjusting for a minority stake in Brazil's iFood).

The UK is the key asset, accounting for more than half the orders and the vast majority of profit. Just Eat had well over 90% market share there in 2015, but this has fallen to a little over half today, and a distant third position in the large inner London market behind Deliveroo and Uber Eats. Takeaway.com only obtained control of the business in April 2020, after an antitrust review, so we will have to wait to observe any turnaround. Management's analysis of the issues is clear: Just Eat's brand and restaurant selection is associated with low-end independent pizzas, kebabs and chicken shops, and lacks premium chains and sushi, dim sum and salads; the user interface needs upgrading; the logistics capability needs to be stepped up; and Just Eat must revive its business in Deliveroo's London stronghold. Conversely, the business has major strengths: outside of London, its market share may be 65%+, and in many smaller local markets it has a monopoly. With independent, own-delivery restaurants, Just Eat continues to be almost completely dominant. Its national scale gives it heft in advertising that means it dominates national TV slots for the peak weekend ordering periods. From here, it is easier for Just Eat to encroach on Deliveroo and Uber Eats' businesses than it is for those businesses to take further share. A large chunk of the premium restaurant supply is composed of chains, particularly outside London. This means Just Eat can make a big difference to its proposition with just a few national agreements, compared to the thousands and thousands of individual marketplace restaurants that Deliveroo needs to replicate its offer. We have already seen this reflected in agreements with McDonald's and Greggs and expect to see further significant agreements in the coming months, supported by a steady build-out of smaller chains and independent inventory.

Most importantly, its logistics model competitors bleed cash even at scale. In 2018, the most recent accounts available, Deliveroo (Roofoods Ltd) generated a sub-20% gross margin, and made an operating loss of GBP 257m, on revenue of GBP 476m. We don't see this changing enough for the business to make a profit. Although the UK is more hospitable to the logistics model than continental Europe, given its acceptance of the gig economy, the unit economics are still too tough. Consumers typically spend about twenty pounds on an order. This means a delivery in the UK typically costs five to six pounds. Even with the logistics platform taking around a third of the total bill, gross profit per order isn't much more than a pound. Deliveroo's group overheads were around GBP5 per order in 2018. Loss-making competition won't go away soon, especially now that the antitrust authority seems likely to approve Amazon's investment in Deliveroo. But we are optimistic about Just Eat's longer term prospects in the UK and other markets now that it has an owner who is willing and able to invest in protecting its market position, making life even harder, and more expensive, for the competition.

With Grubhub in the US the strategic situation is different, albeit the arc of the story is familiar. Five years ago it was the dominant food delivery marketplace but has steadily lost share to the point that it is now the third largest player nationally, behind loss-making logistics model operators DoorDash, Inc. (which is the clear number one) and Uber Eats.

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However, competition is much more localised than the UK, so Grubhub's national position is a combination of some strongholds in its oldest markets, and much weaker positions across the rest of the country. Until DoorDash began to transform the market, US food delivery was highly concentrated in a few dense urban areas, particularly New York. Grubhub still dominates there today - we estimate it accounted for about half of Grubhub's GMV and most of its reported profit in 2019. Its competitive position is supported by a high density of ordering for lunch and dinner in Manhattan offices, mainly catered for by Grubhub's Seamless unit, which already offers access to almost all of the (unusually independent-biased) restaurant supply in the city. It is difficult for competitors to establish a meaningful position in this environment. A big jump in working from home and increasingly active local politicians, who have imposed a punitive temporary cap on aggregator fees since restaurants were forced to shut down, cloud the current picture, but longer term we expect Grubhub's New York business to continue to be resilient.

Outside of New York Grubhub faced two waves of aggressive competition over the last 3-4 years: first from Uber, which signed an exclusive deal with McDonald's, piggybacking on their brand power to develop a large customer base, albeit still mostly in large cities, and then building a broader restaurant supply on the back of that customer base. And second from DoorDash, which took hundreds of millions in funding to expand aggressively across smaller towns and suburban markets where there was an affluent consumer population and next to no competition. It turbocharged growth by adding unpartnered restaurants to its platform (basically taking orders for places that it didn't have a contract with). This was a clever way of getting restaurants to sign partnership agreements – rather than engaging in door-to-door sales to establish a restaurant supply base in a market where delivery demand was unproven, DoorDash simply started taking orders. It could then go to a restaurant with proven demand, making its platform an easy sell.

The logistics unit economics are more favourable in the US. Grubhub discloses that it pays couriers a little over USD 6 per delivery through its network. We estimate that Uber Eats does better, closer to USD 5.50 (partly down to larger scale, and partly the share of lower labour cost markets in its volume mix). US consumers pay more for delivery too: Grubhub's average of almost USD 5 in consumer fees per logistics order almost covers the delivery cost. Charging restaurants a slightly higher commission can make up the remaining difference. Our analysis validates Grubhub's claim that there isn't much economic difference between a marketplace and a logistics order from an independent restaurant. The snag is the prevalence of huge QSR chains which sell low-priced food (resulting in small commissions) and don't need to pay aggregators to generate demand for them. Uber discloses that QSR chains pay commissions of 10-15% of order value, compared to 25-30% for independent restaurants. On these numbers, QSR orders are structurally unprofitable, but still important given the need to present consumers with a full restaurant selection. US aggregators need to manage their order mix as well as working hard to generate efficiencies in their logistics networks. We estimate that QSRs account for almost 40% of Uber Eats' US orders, compared with under 15% of Grubhub's. This and much more aggressive marketing activity from Uber Eats explains the difference in profitability – Uber Eats produced losses totalling 10% of its GMV in 2019, compared to Grubhub's profit of 3%. Combined we estimate Grubhub's three main competitors (DoorDash, Uber Eats and Postmates) generated an aggregate operating loss of well over USD 1bn in 2019, and potentially closer to USD 2bn.

As with Just East, Grubhub did not push back in a significant way with its own logistics offering until 2018. Given the better unit economics this was a huge mistake. But when it did retaliate it went in much harder to defend its business: 45% of its orders were delivered by its own network in the first quarter of this year. It copied DoorDash's unpartnered restaurant in strategy from late 2019 too, leading to an increase of nearly half in its partnered supply over seven months, closing most of the gap with the competition. Grubhub certainly ceded market share, but in this competitive environment it's remarkable to note that it still managed to grow orders 13% in 2019 and generate almost USD 200m EBITDA.

Just desserts

We believe Grubhub now has largely the right strategy and that it will be in a much stronger position as part of JET. But is JET right to buy this business: the third-placed player which is losing share in a hyper-competitive industry which is burning billions of dollars? It is certainly the riskiest transaction that Jitse Groen has made so far, and the market is unconvinced (JET shares fell almost 20% in the few days after the announcement, although they have since recovered all of that). We have mixed feelings about this deal – we are not sure the company needed to compete outside of Europe, and the USD 7.3bn price tag is punchy – but even so our position in JET still seems a very attractive investment to us.

The agreed deal would result in JET shareholders owning 70% of the combined business. This implies a combined enterprise value of about EUR 20bn. JET's Dutch business highlights the profit potential of the business model, achieving

EBITDA of 7.3% of the gross bookings (about 50% of revenue) in 2019. The German business is likely to match the Dutch margins as volumes expand into the cost base, given it has a similarly dominant position and its advertising is already ubiquitous. And whilst the UK operation faces more competition in London and other large urban markets, it is also a highly profitable, likely to generate EBITDA margins in excess of 5% of GMV. These three businesses account for almost EUR 8bn of run-rate GMV today, and we expect well over EUR 10bn in 2022, generating EBITDA of almost EUR 700m and FCF of c. EUR 500m, and still growing in the mid-teens or faster at that point. These estimates largely ignore the nascent B2B proposition (i.e. delivering lunch to office workers) which could almost double the addressable market (based on JET's Israeli business and Grubhub's Seamless), and don't assume any improvement in Just Eat UK's competitive position. We think these three businesses are worth in the region of EUR 10-12bn today and potentially significantly more if B2B takes off. JET also owns a minority stake in iFood, the leader in the Brazilian food delivery market, which at some point is likely to be sold to Naspers Limited, the ultimate majority owner – we value this asset at EUR 1-1.5bn. This leaves the remainder valued at c. EUR 6-9bn (not much more than the cost of acquiring GrubHub), for businesses we expect to transact c.EUR 16bn of GMV in 2022. A chunk of that value comes from a profitable, dominant position in New York, and JET is also the market leader in Canada, Italy, Spain and Poland. There is plenty of potential upside from them winning in other markets when unprofitable logistics players eventually do run out of rope. This will take time but, as JET's CEO has eloquently explained, having a highly profitable core business with scale means they are best positioned to win. We'll leave the last words to him:

> "we call this [Netherlands and Germany] internally, the fortress. To have a fortress to defend is incredibly valuable. A big global company and certainly a big global company that is so EBITDA-positive can choose which battles are important to it. We are agnostic to whether we have to defend our business or expand our business in London, in Paris, in Berlin or in New York. We do not care as a large business, and our competitors should know that we do not care about it. We will take the right decisions for the business […] there's quite some players currently in the food delivery markets that are burning a lot of cash to try to push out very successful market leaders from their markets. It is pretty obvious to us that as long as we are [significantly] EBITDA positive and very dominant in the markets that actually matter, that cannot happen to us, and on top of that, we're going to push back… we are going to be awfully, awfully difficult to compete with".

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