Last quarter, we reviewed and analyzed our investments of the past few years to see what has worked and what hasn't, focusing first on those that lost money. We are continuing with the promised second part, focusing now on the winning investments. We want to analyze not only the results, but more importantly, the decision-making and investment process involved. The goal, of course, is to see what lessons can be learned and to further improve our investing processes for the future.

Lindblad Expeditions

We invested in Lindblad Expeditions in mid-2015. Lindblad is a specialty expedition cruise company focused on small nature-oriented cruises, and we were attracted to their juicy unit economics (with extremely high-end experiences and prices and industry-leading net yields) and the long-run growth story that was gaining ground as they built out further capacity. As you can well imagine, COVID hit the company quite severely, with all cruises canceled for more than a year, as well as higher costs when they did finally begin to restart in late 2021. Recent inflation has not been doing their profitability any favors either.

The first question to be faced during COVID was whether to jettison Lindblad or stick with it through the turmoil. As we discussed in last quarter's piece, the lens we used to judge whether to stick with our investments was a company's resilience. To quote our writings on risk from a number of years ago:

> On the investment side, we seek to invest only in companies which are both Predictable and Resilient. … Resilient companies are companies that can survive and recover from an unexpected shock, be it a global macroeconomic slowdown, regional troubles, or an idiosyncratic company-specific issue. Not everything will always go as expected. Even though we as long-term investors are ready to ride out rough patches, this will not help us if the companies we invest in are not themselves equipped to ride out recessions, business cycles, or other issues. Hence the insistence on investing only in Resilient companies. In judging a company's resilience, there are a number of factors to consider. Resilient companies need strong balance sheets, with little or no debt. What debt they have must be spread out over time so as to lower the risk of needing to refinance during a credit freeze. Resilient companies need to have relatively little reliance on a single big customer or supplier, they need to have low risk of highly disruptive regulatory changes, and they need to have a flexible and secure business model. Resilient companies are generally profitable; money-losing businesses are quite often only one misstep from disaster. Resilient companies need to be in control of their future, not at the mercy of circumstance.

Despite the protracted total cessation of business forcibly imposed on Lindblad by circumstances outside their control, Lindblad remained in a surprisingly healthy financial situation. Their debt was manageable and laddered, they were not in any risk of breaking debt covenants, their monthly burn rate was limited, and they had a strong enough balance sheet to weather the hurricane. In our opinion, Lindblad was actually strong enough to withstand an even worse crisis than that which occurred with COVID. (As a reminder, the world emphatically did not end up experiencing the worst-case scenarios that were on the table in March 2020). We analyzed the company carefully, reviewed the company's plans and future runway, and deemed Lindblad to be highly resilient. We believe that future events have borne out the correctness of our analysis, with Lindblad's stock jumping over the course of 2020 more than 5x from its COVID lows.

A more interesting question was whether to reinvest even more money into Lindblad as it dropped as much as 80% in the early days of COVID. We ultimately decided that with fast-moving fluid events and a small but real risk of total disaster, it did not behoove us to place even more money in a higher risk position such as Lindblad. We believe this was the correct decision for an already highly concentrated fund.

We believe that the Lindblad investment underlines a major theme that keeps cropping up in this postmortem exercise. Valuation matters. Valuation matters a lot. When companies are deeply undervalued, when investments are made at valuations which are low and undemanding, future events do not have to go perfectly for the investment to be successful. Future events don't even have to go all that well. Things can and will go wrong in any company. With deeply undervalued companies, a whole lot can go wrong and you will still end up ahead.

Lindblad is an excellent example of this. COVID was a surprise out of left field, an order of magnitude greater crisis than we could have expected Lindblad to have to face. But being as strong a company as they were, and crucially, as undervalued as their stock was, we still did pretty well with our investment. Surprisingly, even with virtually no revenue for 2020, Lindblad's stock ended the year higher than it entered! That is the power of being so undervalued to begin with.

Our biggest mistake with Lindblad was holding on too long after it had mostly recovered. In our 2020 Portfolio Update written in early 2021, with the stock trading around $16 (more than 5x up from its COVID lows), we suggested that if the stock continued to rise significantly, we would consider selling. We should have taken our advice and sold a few months later when the stock rose above $20. Especially considering the dilution experienced with their 2020 convertible debt raise and their higher cost structure post-COVID, $20 a share was more than a fair price, and we should have taken advantage. Instead, once again we were biased to inaction, even when action was the correct move. In the end, we sold our position in Lindblad near the end of the year at a lower price, as the risks of inflation made the investment less attractive.

Ultimately, we did decently with our investment, with a 13.8% IRR over the approximately 6.5 years that we were invested. This just highlights that when buying deeply undervalued companies to begin with, even if huge risks come to pass (total business shutdown!, highly unfavorable equity raise!, sharp rise in debt and operating expenses!), the margin of safety incorporated into the initial investment still allows you to come out ahead.

Grade: B

Twitter Merger Arbitrage

Twitter was a home run investment, a fat pitch down the center that we hit straight out of the park. If we could get a bunch of such great investment opportunities, we would be quite satisfied. Unfortunately, we do not expect such a fantastic opportunity to appear again anytime soon.

When Elon Musk formally contracted to buy Twitter and the spread remained absurdly large, all sorts of theories were bandied about how Musk would be able to weasel out of the signed deal. For someone who spent time to look at the facts and the law, none of the theories held any water. There was a copious amount of information available for analysis, especially when the lawsuits started flying, with briefings and court hearings available for public perusal. Yet both the mainstream reporting and investor reaction was confused and quite often entirely wrong-headed. For a much more detailed analysis of the issues at hand and the numerous myths surrounding the case, I refer you to our paper on the Twitter Acquisition from Q3 2022.

We entered our Twitter position in early June 2022, before Musk formally terminated the deal. We would have done even better with our investment if we would have waited to enter until *after* Musk terminated the deal, but there was no guarantee that the infamously mercurial Musk would actually do so, and the mouth-watering gap between the share price and acquisition price was too good to pass up on. We did attempt to enlarge our position after the stock dropped sharply in the wake of the formal termination letter, but our stink bid was not hit, and the stock recovered relatively quickly.

The Twitter situation was a unique sort of investment for us, as we normally avoid merger arbitrage like the plague. Normally, merger arbitrage involves collecting relatively small spreads and then getting hit with massive losses when something unexpectedly goes wrong, the proverbial picking up nickels in front of a steamroller. When the spreads are unusually large and lucrative, it is generally because the binary risk of the deal falling through is judged by the market to be unusually large. Twitter was a unique case, where there was a very large spread (about 40%), and yet the risk of the deal falling through was extremely small. In fact, we judged the highest risk to be that the Twitter board might roll over and just let Musk walk away. As time went on, it became crystal clear that that was not going to happen.

The Twitter merger arbitrage was a binary situation, with steep losses pretty much guaranteed if the deal fell through. Although we judged that occurrence to be quite unlikely, we still structured and sized the investment differently than we usually do. We bought a smaller position than normal for the Fund, about 16% of the fund's net assets upon entry. To increase our exposure to the upside (while also increasing the extent of our downside if the deal fell through, which we deemed very remote), we invested in long-term options instead of straight up stock. This allowed us to turn a profit of close to 80% when the deal closed, although the price spread on the stock was only about 40%. And to mitigate the risk of the matter being dragged out in courts for longer than expected, we bought options that expired more than a year later. This gave us far more time than possibly necessary for the famously quick Delaware court process to conclude, including appeals and any necessary enforcement. Indeed, by the end of October, the saga was already over.

As we've said before, Twitter was truly the arbitrage of the century. In just under five months, we had a 77% gain, for an IRR of 306%! We would do such a deal again in a heartbeat, but unfortunately, we do not expect to get such a great investment again anytime soon. We stress that we are not looking to start investing in merger arbitrage as a general strategy, despite some relatively attractive situations recently (see Jet Blue–Spirit–Frontier, Microsoft–Activision). Despite the temptation, we are 100% not starting to do merger arbs, and they generally still don't make sense for the Fund for the usual reasons detailed above. Twitter was truly a special case.

Grade: A+

Viemed Healthcare

We invested in Viemed Healthcare in the first half of 2018. As the name indicates, Viemed is a healthcare company, focusing mainly on providing ventilators for late-stage COPD patients. We saw in Viemed a rapidly growing, highly profitable company, with a low valuation and a highly favorable risk/reward profile. As we said at the time (see our Q2 2018 paper on Viemed), we had not seen such a superbly attractive opportunity for some years.

Once again, by buying a company at a deep discount to intrinsic value, we did extremely well, despite hiccups along the way. COVID caused difficulties with third-party provider access to hospitals and the necessary hospital referrals, which caused their core revenue line of ventilators to essentially flatline for two years. Even after the world and the hospitals reopened, Viemed struggled to grow at their pre-COVID blistering pace. Other issues that hurt the stock were multiple Medicare audits (which they ultimately fully won, as we predicted they would in our annual updates discussing the issue), the inclusion of ventilators in Competitive Bidding and then the subsequent temporary halt to the entire Competitive Bidding program, and the Philips recall of their CPAP machines which rocked market supply.

Despite all these challenges and more, our investment in Viemed was everything we could hope for, with an IRR of about 24.7% over the approximately 5 years that we were invested. We started selling down our position at the end of 2020, continued selling over 2021 and 2022, and have recently exited the position entirely. As detailed in our yearly Portfolio Updates, our main reasons for selling have been a sense of management being distracted by non-core business lines and acquisitions, growing inflation risks, and perhaps most importantly, highly inflated stock-based compensation (in the form of both stock options and phantom share programs) that amounted to an unconscionable percentage of adjusted net income and which showed no signs of coming down over time.

Grade: A

Lessons Learned

Perhaps unsurprisingly, the lessons we see here are similar to what we saw in the first half of our postmortem. One, valuation matters. Valuation always matters. Paying up too much for growth is dangerous. When investing in companies at deeply undervalued prices, even when things go wrong — even when lots of things go wrong — you often still make money because you purchased the stock at such an undervalued price to begin with. Viemed and Lindblad both evidenced this dynamic, each in their own way.

Two, we have at times been biased too much to inaction, especially when it came to selling decisions. We were too slow to take corrective action, and our results have suffered for it. Both with investments that lost us money and with investments that made us money, we have tended to hold them too long past the expiration date. Having noticed this theme, we will strive to correct this bias in the future. While we still expect to be deliberate in our analysis and take our time in making decisions, we will have a sure trigger finger once we have reached our conclusion. We will strive not to confuse deliberate consideration with paralysis, and we will nudge the needle a few notches over in the direction of action vs. inaction.

We found this series of postmortems useful and edifying, and we believe it will make us better investors in the future. We hope you enjoyed the series as well.