



*The following, excerpted from Letter to Partners #27, exemplifies my approach to identifying and evaluating opportunities:*

### **Creating a framework for public market software investments**

There are few places in the investment world where the laws of physics seem to bend as much as they do in software. Capital-light, infinitely scalable, and blessed with margins that most industries can only dream of, great software businesses defy gravity for long stretches. But like all great investments, the key is not just to recognize a company's current excellence but to judge whether that excellence is durable - whether the competitive advantages of today will still be intact and even greater a decade from now.

Over the last two quarters, I've dedicated considerable time to studying European software companies - a deep dive initially sparked by three of our UK core holdings and their digital transformation efforts (MAB1, TPGF, and LSL). These high-quality companies are channelling meaningful investments into digitizing their business models and workflows, positioning technology/software as a key driver for long-term efficiency and customer satisfaction, while also broadening their moats and enhancing scalability.

When I first began exploring European pure-play software firms, I wasn't entirely sure where to start or what specific business model attributes to focus on. Anchored by my thesis on the recovery in the European and UK housing, construction, and mortgage broking markets, I targeted software companies with direct exposure to these sectors. I identified two particularly attractive names, and after thorough due diligence - reviewing annual reports, engaging with management, and building valuation models - I developed a clearer understanding.

Notably, software stocks often appear "expensive" when evaluated on a 1-2 year forward multiple basis, a common point of resistance among fellow investors. Some shy away from these stocks, dismissing them as perpetually costly and therefore unlikely to deliver superior returns. I believe this reluctance stems from a discomfort of how to assess these assets properly. Consequently, I find it both intellectually stimulating and strategically vital to develop a framework that can better capture the long-term value potential in this space.

Currently, my investment approach in software is built on three guiding pillars: the private equity discipline exemplified by standout software investors such as Thoma Bravo & Vista Equity; the transformative insights from Peter Thiel's book *Zero to One*; and slightly tweaking the enduring lessons on scale economies shared as articulated by the Nomad Partnership. These principles serve as a framework to distinguish enduring franchises from those likely to falter under competitive pressures.

Applying the strategies of top-tier private market software investors to public market software stocks can help identify undervalued, high-quality companies. Leading private equity firms prioritize mission-critical, high-retention software with strong recurring revenues - principles that also apply to select public market opportunities. In addition, the most compelling firms are technology leaders in their verticals, offer SaaS-based cloud solutions, and maintain control over their customer data.

### **The AI shift: A new layer of competitive advantage?**

We are entering a new phase of software investing; one where artificial intelligence is becoming a competitive differentiator at an unprecedented scale. While AI and machine learning has been used by software companies for decades, the success of models like ChatGPT is not just about technological achievement - it's about the fact that these systems are passing the Turing test, making them viable replacements for human agents. This is not a minor development; it is a fundamental shift in how software is monetized and scaled.

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Many firms are now racing to integrate AI into their offerings, but the winners will be those that can embed these capabilities deeply within their core products – turning AI from a feature into an essential, irreplaceable function. This transition will create new moats but also new risks: if everyone can access the same AI models, where does differentiation come from? Our approach is to look for companies that don't just *use* AI but *own* their AI – whether through proprietary datasets, unique infrastructure, or deeply embedded workflows.

Based on my current understanding – after reading hundreds of pages, listening to countless hours of podcasts, and speaking with numerous experts, founders, and managers – it has become clear that the companies best positioned to benefit from the Agentic AI revolution will be those that own their cloud infrastructure, have developed an in-house proprietary data lake, and possess a deep and expansive dataset as well as leverage on it. These factors are crucial for building, marketing, and selling the next generation of AI-driven innovations.

## **The market's great underestimation: Momentum and long-term thinking**

One of the persistent inefficiencies I observe is the market's failure to properly price momentum. Investors often assume that high growth must slow down far earlier than it actually does and that high margins are far less sustainable than they appear. As a result, many hesitate to pay a relatively high multiple for a company that has profitably grown at high CAGRs and is expected to continue doing so for the foreseeable future. Instead, they gravitate toward classical value plays, where the prospects seem more straightforward to assess.

Peter Thiel – co-founder of PayPal and Palantir, and an early investor in Airbnb, Facebook, SpaceX, Stripe, Spotify, and Trade Republic, among others – provides an interesting case study. I was surprised to learn that while he participated in Facebook's Series A, he skipped Series B, only to return for Series C. When asked why he missed out, he explained that at the time, he believed he had already made a great return, and that the valuation seemed a bit too high. Interestingly, he later realized that this wasn't a one-time mistake.

In the same interview, Thiel noted that through further research, he identified a recurring pattern: the market systematically underestimates the persistence of momentum, particularly in high-growth businesses with enduring characteristics. In his book *Zero to One*, he argues that investors should focus (exclusively) on businesses that either are or have the potential to become monopolies. These businesses often start by dominating a small niche, just as Facebook initially did by becoming the social network for Harvard University.

I found his concept of the *creative monopoly* particularly compelling. Such businesses share their advantages with customers in a dynamic way, using excess earnings to invest in innovation, which in turn enhances customer efficiency and effectiveness. Unlike Nomad Partnership's *Scale Economies Shared* principle, exemplified by investments like Costco Wholesale, these businesses do not focus on keeping prices as low as possible to ensure durability. Instead, they leverage their pricing power to sustain competitive advantages and long-term growth.

Strong pricing power and a high-margin profile allow these advantaged businesses to take a long-term view, reinvesting excess earnings into new technological innovations. This, in turn, drives high ROI for their customers, deepening product stickiness and ensuring the durability of their own franchise while strengthening their customers' businesses. Thiel outlines four key characteristics to assess such companies: 1. *Proprietary Technology*, 2. *Network Effects*, 3. *Economies of Scale*, and 4. *Branding*.

## **A portfolio of unfair advantages**

The ultimate goal is to own a portfolio of businesses that, collectively, possess durable unfair advantages. A portfolio like this gives us an edge over time because the market systematically

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underestimates the staying power of these firms. While short-term investors rotate based on quarterly guidance, we aim to capture the long arc of compounding that these businesses can deliver. Warren Buffett has often said that the best investments are those where you would be comfortable if the market shut down for ten years.

The same logic applies to software: we want to own businesses that, even with the constant threat of disruption, are still standing strong – and even stronger – a decade from now. I remain committed to this approach – seeking out high-quality, high-ROCE businesses, understanding their moats, and capitalizing on the market's recurring mistake of underestimating momentum. It is a strategy that, over time, I believe will compound wealth in ways that conventional models fail to predict.

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