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Dear fellow investor

18-months of strongly rising dividends

On February 15th we reached the 18-month milestone since opening the fund. In this time we have achieved several important milestones:

- 65 consecutive correctly predicted dividend increases.[1]
- Average dividend increase of 13.11%.
- 60 investor families, completing our foundational investor group.
- 5 quarterly distributions, including our maiden distribution increase last April.
- Core underlying USD return of 35.18% net, or a compounded annual return of 22.26% net.
- AUD return of 18.04% net, or a compounded annual return of 11.69% net.
- 61 years of continuous empirical validation of the underlying MIT dividend growth philosophy.
- 15 weeks of real-time dividend progress reporting, enabling participants to experience the power and feel of a dividend prediction machine in action.

We see two of the above as particularly significant. Firstly, and this cannot be understated, every single one of our companies remarkably not only maintained but also raised their dividends through the teeth of the pandemic. Secondly, we maintained our 100% prediction success record in identifying those relatively few companies which were able to continue to pay and raise dividends.

The above underlies that in purely financial terms this system has always worked, but when really tested it really worked!

Performance summary:

Dividend performance	
Consecutive dividend increases[2]	65
Average dividend increase	13.11%

[1] See dividend track record attached at the end of this letter.
[2] Correctly predicted in advance by the proprietary DivGro system, from 15 August 2019 onwards.

Return since inception - cumulative (net)[3]	
USD	35.18%
AUD	18.04%

Return since inception - annualized (net)[4]	
USD	22.26%
AUD	11.69%

Rising dividends power rising prices

The famous Gordon Formula – inspired by Professor Myron Gordon at MIT in the late 1950's – demonstrated that over time capital values (i.e. stock prices) must rise at a rate approximately in line with the rate of increase in the company's dividend. Therefore, where a company can sustainably raise its dividend at an above average rate, over time, it will almost certainly translate into an at least commensurate increase in share price. With this in mind, our primary objective is to identify those special companies whose business positioning is such that we can confidently predict in advance such above average dividend increases. DivGro has now built an exceptional **public record of 65 sequential, confirming data points** that showcases its special edge in such dividend prediction.[5]

Indeed, we know of no other investment house anywhere that was willing or able to put its reputation (or money) on the line behind its ability to reliably predict such dividend movements.

The theory hypothesizes, and our own data to date confirms, that if we can continue to predict with relative accuracy above average changes in dividends, above average total returns will follow.

Psychology versus price

DivGro is a unique and special breed of asset class, in the sense that it has been built to be the most psychologically compatible investment system in existence. This is what stands behind our emphasis on dividend increases – an understandable, transparent, tangible, repeatable and psychologically reinforcing process – enabling it to optimally synchronize with most investor's emotional makeup.

In contrast, we think the vast majority of investment alternatives – which are almost always exclusively price dependent – tend to be emotionally destabilizing, largely because of the randomness of short-term price fluctuations. This is also why at DivGro we prefer to relate to dividend changes rather than short-term price performance, wherever possible.

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[3] Class A, net of fees and expenses, inclusive of distributions and accrued rebates, as of 14 February 2021.
[4] See footnote 3.
[5] Even where the underlying stock may have been performing strongly (e.g. Yum China) the system demanded an exit where the possibility of a non-increase was identified as too high.

Where an investment does not sync with an investor's emotions, this tension will usually resolve; either by damaging an investor's psychology or alternatively by damaging the ability to continue to hold that investment. This conflict also explains why even when investors identify a potentially outstanding investment, the investor's outcome is typically much worse than the outcome of the underlying investment. This phenomenon is even true in the context of index-based investing and is shown to apply to institutional investors and individual investors alike.

By better aligning our investment and reporting systems with investor psychology, DivGro's style of investing becomes much more effective than most alternatives for most investors.

By integrating a more supportive psychological and emotional backdrop into the investment system, DivGro is designed to raise the probability that investors actually benefit from a well-chosen investment. In doing so, in purely financial theory terms, DivGro's psychologically compatible paradigm effectively raises an investment's locus on the so-called efficient frontier.

While the system has always worked in purely financial terms, when overlayed with our psychological reinforcements, it increases an investor's benefit when viewed in total utility terms. This is why a DivGro type solution is unique in its ability to function as a foundational building block in investment portfolios.

Low turnover versus no turnover

We enter investments hoping to capture many years of above average dividend growth that will power above average increases in corresponding share prices. However, we always re-examine our existing holdings to assess whether dividend growth is likely to accelerate, stay the same, or decelerate relative to share price movements of our holdings and other potential opportunities.

Since our last letter we have profitably exited a few holdings to make room for new (and previously held) ideas where we think dividend growth prospects are stronger and where we were able to establish our position at very attractive prices.

Specific examples include profitable exits from CDW, Clorox and Air Lease which we have replaced with Sherwin-Williams and Domino's Pizza. Since adding these positions Sherwin-Williams has already announced a significant 23.1% dividend increase.[6]

Why franchisees love Domino's even more than their customers

The pizza category, like the coffee business we discussed in detail in our October 2020 letter,[7] enjoys extremely high unit level gross margins. In pizza these are typically around 80% in contrast to most other fast-food categories which are typically closer to 60%. Whereas most pizza business owners pocket this

[6] DivGro Weekly Dividend Progress newsletter, 19 February 2021.
[7] Available at https://www.divgro.com.au/follow-our-progress.

extra margin, forward thinking Domino's instead shares this fat margin with its franchisees and its customers.

The net result is that customers enjoy the highest value proposition – large 3 topping pizza at $7.99 or any two items for $5.99 each,[8] with the fastest and most reliable delivery service included. Here Domino's is effectively sharing its excess margin with customers by subsidizing a few slices of each pizza and the cost of delivery. This leads to increasingly loyal customers while at the same time making it tougher for existing and potential competitors to compete on an equal footing.

Even more impressive are the franchisee economics. The average U.S new store investment ranges from $300,000 - $350,000.[9] Since about 65% of its business is delivery, Domino's can locate its stores off the high street in small format, lower rent stores. This reduces upfront franchisee investment to significantly less than competing fast-food formats which often require higher traffic, larger footprint locations that demand million-dollar-plus upfront investments. Domino's even designs all menu items to go through the same oven system maximizing efficiency and minimizing investment in store equipment.

The average Domino's store in turn produces ~$158,000 operating profit per year resulting in a franchisee cash-on-cash payback period of 2-3 years.[10] Such high franchisee returns result from Domino's sharing its high margins not only with its ultimate pizza customers but also with its intermediate customer i.e., its franchisees. Taking this one step further, Domino's also charges a lower franchise fee than many other competitors while uniquely including its franchisees in the profits of its supply chain and distribution business (procurement and logistics of dough, sauce, cheese etc.).[11] Because of such amazing franchisee economics the average Domino's U.S. franchisee actually owns 7 units which together deliver an annual profit exceeding $1million (implying a business value of around $10m).[12]

Perhaps the most astounding feature of the Domino's system is that 95% of such franchisees began their Domino's journey as delivery drivers, pizza makers or store hourly workers.[13] Indeed, the hidden jewel in the Domino's system may be this clear path from lower wage employee to successful entrepreneur. In the U.S. alone there are already 760 flourishing Domino's entrepreneurs with average franchisee business values exceeding $10m.[14] It is no surprise that Domino's U.S. franchise agreement renewal rate is 99%.[15]

Another example of this shared success is Domino's use of master franchisees in various international markets such as Australia. These independent businesses are themselves worth a combined ~$15billion, not hugely different to Domino's itself.[16] These master franchisees have their own independent sub-franchisees, all of which are also highly profitable, meaning that the entire Domino's ecosystem participates in the system's benefits across the board.

[8] Domino's Pizza ICR Conference Presentation – 12 January 2021.
[9] Domino's Pizza Investor Presentation – October 2020.
[10] See footnote 8.
[11] Domino's Pizza 2019 Annual Report.
[12] Company filings and DivGro estimates.
[13] See footnote 9.
[14] See footnote 12.
[15] See footnote 11.
[16] Domino's Pizza Enterprises (ASX:DMP), Jubilant FoodWorks (NSE:JUBLFOOD), Domino's Pizza Group PLC (LON:DOM), Alsea SAB de CV (OTCMKTS:ALSSF), DP Eurasia (LON:DPEU)

By sharing the economics of their exceptional model with both customers and franchisees, Domino's has developed a hard-to-replicate virtuous cycle:

→in subsidizing fast delivery and part of the pizza Domino's enhances the value proposition to customers.
→faster delivery and cheaper pizza encourage more customers to purchase more often from Domino's.
→more customers ordering more frequently translates into higher sales and store level profitability.
→increased store level profitability encourages franchisees to invest in opening more stores.
→new stores increase system density meaning faster delivery and improving customer satisfaction.
→satisfied customers return to Domino's which in turn re-invests in further enhancing value and delivery.

Share the benefits again, repeat, and keep repeating.

Because Domino's is so well aligned with customers and franchisees, we expect the residual profitability (which accrues to us, the ultimate shareholders) to keep growing strongly long into the future. Domino's is pressing its advantage aggressively: since 2014, Domino's share of U.S. pizza delivery has grown from 24% to 36%,[17] while fending off delivery aggregators at the same time.

We expect a long runway of continued expansion ahead as it borrows from the Starbucks playbook in 'fortressing' out competition by rapidly filling in additional units in existing territories.

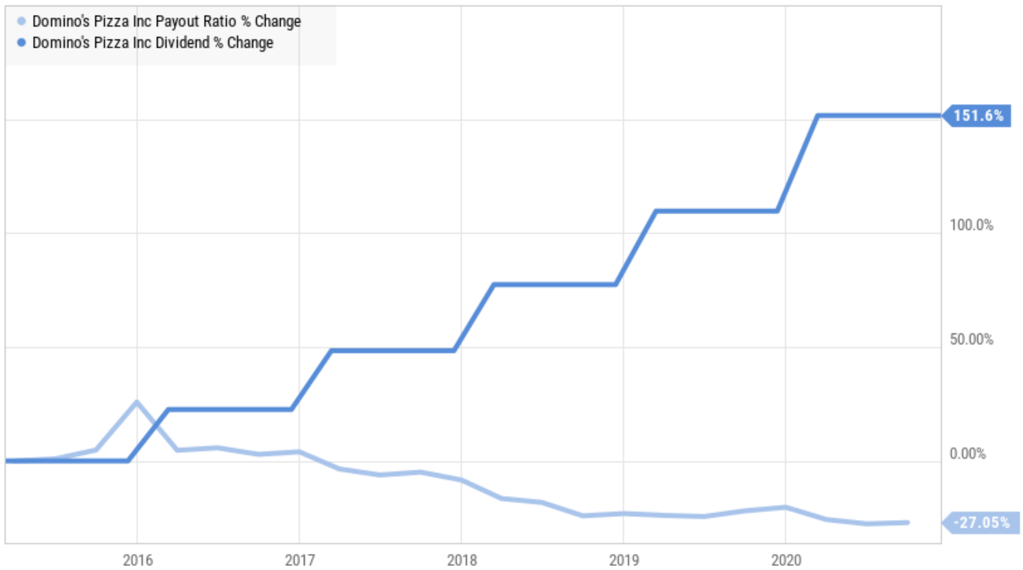
While some analysts take the simplistic short-term view that greater store density might cause cannibalization, early evidence in the UK and India demonstrates the long-term competitive strength of this strategy.[18] By adding incremental units Domino's improves network density thereby shortening delivery times (enhancing value), gains further supply chain efficiencies and enhances local advertising return on spend. Most importantly, Domino's is physically locking out competition. Not only does an aspiring competitor need to challenge Domino's on food quality, price and delivery speed, it will have to do so while physically more distant from the customer.

We expect this to also apply against pizza competitors who utilize third party delivery aggregators. Further delivery distance means more costly deliveries which are ultimately paid for by the customer or absorbed by the restaurant. A pizza that travelled further is also not as hot and fresh, while the aggregator will demand a cut of the margin eroding the value proposition further. With or without an aggregator, to provide a value proposition that resembles Domino's, competitors will need to sell pizza that is not as hot and fresh, or is more expensive, and in every case at lower profitability levels than they are accustomed to.

Domino's is so confident in its fortressing strategy that where franchisees choose to pass on the opportunity to open additional stores in their existing territories, Domino's is investing in these new stores on its own account. Literally locking competitors out territory by territory coupled with a willingness to share excess profitability with franchisees and customers is a recipe we think will allow Domino's to continue to win in pizza over the very long-term.

[17] Company filings, The NPD Group/Crest.
[18] Domino's 2019 Investor Day presentation.

From our dividend perspective, what is abundantly clear is Domino's cashflow generating ability and how this cash has powered its dividend. Using the last 5 years as a guide, Domino's has increased its dividend from 31c per share per quarter to 78c per share per quarter, a compounded annual growth rate of approximately 20%, while at the same time even reducing its payout ratio. This is a wonderful combination because Domino's is reinvesting aggressively in its business while sending growing dividends our way.



Administrative update

The fund's foundational Class A closed to new investors on the 1st of February upon reaching its stated milestone of 60 investor families, as indicated in the October letter. As promised, all such foundational Class A investors will retain their foundational investor fee arrangements on existing and future amounts they invest in the fund. This will be implemented by way of a rebate to Class A investors on a semi-annual basis.

We are pleased to advise that Class B is now open to all new investors.

Documentation for both classes A and B has been updated and is available on request.

Thanks again for your continued support.

Sincerely,

Jonathan & Barney

DivGro Fund dividend increases[19] [20]

Increase Number	Declaration Date	Company Ticker	Dividend Increase %
1	14-Sep-19	AMT	20.25%
2	18-Sep-19	MSFT	10.87%
3	19-Sep-19	MCD*	7.76%
4	19-Sep-19	TXN	16.88%
5	22-Oct-19	V	20.00%
6	29-Oct-19	CTAS	24.39%
7	30-Oct-19	SBUX	13.89%
8	31-Oct-19	CDW*	28.81%
9	01-Nov-19	ABBV*	10.28%
10	07-Nov-19	AL*	15.38%
11	14-Nov-19	NKE	11.36%
12	15-Nov-19	ROP	10.81%
13	25-Nov-19	BDX*	2.60%
14	03-Dec-19	MA	21.21%
15	04-Dec-19	SYK	10.58%
16	04-Dec-19	ECL	2.17%
17	11-Dec-19	ZTS	21.95%
18	12-Dec-19	AMT	20.24%
19	13-Dec-19	ABT	12.50%
20	20-Jan-20	MTY.TO*	12.12%
21	24-Jan-20	YUM	11.90%
22	29-Jan-20	MKTX	17.65%
23	29-Jan-20	SPGI	17.54%
24	29-Jan-20	SCHW*	5.88%
25	05-Feb-20	CME	13.33%
26	06-Feb-20	ICE*	9.09%
27	10-Feb-20	QSR*	4.00%
28	20-Feb-20	DPZ*†	20.00%
29	20-Feb-20	SBAC	25.68%
30	24-Feb-20	HD	10.29%
31	13-Mar-20	AMT	20.00%
32	01-Apr-20	WSO	10.94%
33	15-Apr-20	COST	7.69%
34	23-Apr-20	POOL	5.45%
35	19-May-20	AMT	19.57%
36	21-May-20	MDT*	7.41%
37	28-Jul-20	MSCI*†*	14.71%
38	21-Aug-20	LOW	9.09%
39	10-Sep-20	AMT	20.00%
40	15-Sep-20	MSFT	9.80%

[19] * represents companies no longer in the DivGro Fund portfolio.
[20] † reintroduced as a holding in the DivGro Fund.

41	17-Sep-20	TXN	13.33%
42	30-Sep-20	SBUX	9.76%
43	23-Oct-20	V	6.67%
44	27-Oct-20	CTAS	10.20%
45	30-Oct-20	ABBV*	10.17%
46	02-Nov-20	CDW*	5.26%
47	09-Nov-20	AL*	6.67%
48	12-Nov-20	ROP	9.76%
49	20-Nov-20	NKE	12.24%
50	02-Dec-20	SYK	9.57%
51	03-Dec-20	ECL	2.13%
52	03-Dec-20	AMT	19.80%
53	08-Dec-20	MA	10.00%
54	09-Dec-20	ZTS	25.00%
55	11-Dec-20	ABT	25.00%
56	19-Jan-21	CTAS	6.76%
57	27-Jan-21	SPGI	14.93%
58	27-Jan-21	MKTX	10.00%
59	01-Feb-21	YUM	6.38%
60	04-Feb-21	CME	5.88%
61	09-Feb-21	MCO	10.71%
62	11-Feb-21	WSO	9.86%
63	17-Feb-21	SHW	23.13%
64	22-Feb-21	SBAC	24.73%
65	23-Feb-21	HD	10.00%
		Average	**13.11%**

Important disclaimer

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