Tao Value Q3 2018 Letter

October 30th, 2018

For the quarter ended September 30th, 2018, Tao Value recorded a return of +5.51%, compared to +4.42% of MSCI All Country World Index (ACWI). As a reminder, the reason for choosing ACWI as a reference, is because it's an approximation of opportunity cost for an investor who can easily buy and hold an ETF for broad global stock markets. It doesn't imply our strategy will have comparable exposures, as our strategy primarily invests in US and Greater China markets. Due to concerns of slower growth and a potential trade war between US and China, the past quarter has seen big selloff for many Chinese stocks, local and foreign listed alike (MSCI China index returned -7.52% over Q2 2018). Our portfolio is not immune to this market reaction. On breakdown, our China related exposure had -351 bps contribution, whereas non-China exposure contributed +800 bps.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year/YTD
2017	+1.94%	+2.34%	+0.33%	+2.80%	+4.14%	+0.07%	+2.65%	+1.76%	+1.31%	+4.69%	+1.34%	+1.60%	**+27.91%**
2018	+2.07%	-3.86%	-3.74%	-0.80%	+4.81%	+2.99%	+2.20%	+4.16%	-0.87%				**+6.75%**
Since Inception (*January 1st, 2017)													**+36.54%**
Annualized													**+19.48%**

Contributors & Detractors

Contributors		Detractors	
Position	*Performance (bps)*	*Position*	*Performance (bps)*
Long CACC	328	Long YY	-204
Long NXRT	146	Long 1448 HK	-162
Long TEAM	140	Long JD	-60

This quarter, our largest contributor is Credit Acceptance (ticker: CACC) of +328 bps. The second and third contributors are NexPoint Residential (ticker: NXRT) and Atlassian (ticker: TEAM), contributing +146 bps & +140 bps respectively.

All three names happened to be long time holdings from inception in our "Great Operation at a Reasonable Price" bucket. I will comment Credit Acceptance (CACC) further in below "Top 3 Positions" section.

As for NexPoint Residential (NXRT), albeit stock's good performance, there is actually new information impacts our key assumption. As pointed out in last quarter's letter, I've noticed their deal flow in turning over properties got slower compared to past years. There was still no acquisition done this quarter. According to communication with analyst, NXRT has already closed the deal to sell Southpoint Reserve at Stoney Creek (which has been reported as "Held for Sale Property" for 4 quarters), however is still waiting for an acquisition to pair it up. Although asset turnover slowdown will heavily impact expected return for a flipper, the “flip” side is that the management appears disciplined and didn’t pay up just for acquisition’s sake.

Atlassian (TEAM) is among the best enterprise SaaS businesses, with Free Cash Flow margin + revenue growth rate still well above 60% (a metric over 40% is deemed a good SaaS business by industry). As a long-time user, I know well about the quality and stickiness of its products. The challenge for TEAM is to keep its growth (potentially out to non-IT functions) as well as capital allocation. One interesting observation for the capital allocation is that they spent quite a lot of resource on building Stride, a new generation of collaboration IM product, just to suddenly scrap it. Interestingly, Atlassian was able to sell Stride along with its legacy Hipchat product in a partnership deal to Slack, a highly adored collaboration software business by the industry. This deal not only landed Atlassian a “small but symbolically important” equity investment in Slack but also formed product alliance with Slack which is a very positive thing. As mentioned before, our starting position was very small, but it got more material as its price already quadrupled from our initial purchase.

The largest detractor this quarter is YY (ticker: YY) with -204 bps. It was followed by Fu Shou Yuan (ticker: 1448 HK) and JD (ticker: JD), contributing -162 bps and -60 bps respectively.

It not coincidence that all three largest detractors are Chinese companies for the market action mentioned before. The most notable updates for YY Inc (YY) is in its industry’s competitive landscape. There are many buzzes around a new type of entertainment intermediary called short video (e.g. Douyin), and financial media claims it will bring the end to live streaming. I disagree with that reasoning. In essence, YY succeeded because it has been the most effective direct monetization of influence, thus will fail once a better monetization model of influence emerges. However short video is not such one in my opinion. It is more possibly going with an indirect monetization model (i.e. advertising). If we see live stream as live concert (customers consume live experiences), short video is more comparable to CDs or iTunes (customers consume recorded content), which is a supplementary distribution channel of influence. It is arguable that short video may help hosts extend their influences, thus could be a good thing for streaming platform. On the other hand, if additional indirect monetization became substantial, content creators could get “lazier” on live streaming, thus may shrink YY’s addressable markets. Overall, I still observed consistently that many YY hosts remained streaming actively while having opened & maintained Douyin account.

In my last letter, I viewed Fu Shou Yuan (1448 HK) was somewhat overvalued by Mr. Market but decided to remain holding as it qualified for my “great operation at reasonable price” bucket. That decision cost us dearly as we saw a sharp reversion of valuation this quarter (the stock returned -30.42%). On fundamental terms, the company, however, is not different than the same company a year ago.

Regarding JD, our initiation of a position, although at 52-weeks low at that point of time, may be ill-timed. Founder CEO Richard Liu got involved in a sexual assault scandal in a backdrop of Chinese tech selloff. The stock kept falling 33% over the quarter. In general, price drop before I fully build my desired position is an exciting thing as I will be able to scoop up shares at better prices. However, I have halted adding on JD as its key man and political risk is hard to re-evaluate given limited new information at this point. An additional reason is that I think I identified another exciting Chinese e-commerce business, Pinduoduo, which might be a better use of our capital to participate in this market.

Top 3 Positions

Our top 2 positions are still Credit Acceptance (ticker: CACC) and Alphabet (ticker: GOOG). Our Cash position rose to third due to a few corporate events and position exits.

Credit Acceptance (CACC) had a very favorable Q2 2018, benefiting from both loan volume growth per dealer & better than expected collection cross loan vintages. The stock price rallied 16% on the earning release. For position control purpose, I have trimmed the position slightly. In light of raising interest rate, I think that is an adversity for CACC in remaining such high profitability for new loans, however the flip side is that higher rates usually hurt its competitors worse thus could help CACC to expand more effectively. Overall offsetting effects don't drastically change the competitiveness of this business.

Portfolio Updates

Berkshire Hathaway (ticker: BRK B)

Berkshire Hathaway (BRK B) is a new position in "Great Operation at a Reasonable Price" category. The greatness of this business needs little justification given Warren Buffett's decades of prudent and extraordinary capital allocation track record. The only thing we need to get comfortable is its price, i.e. why is the current price a good one to own this business. Since 2012, Buffett communicated that a hard bottom for his company's stock is 1.2 * book value, or he will buy back any shares traded below that. Recently Buffett however indicated he is thinking about lower this bar further because he believes the stock is significantly undervalued compared to its intrinsic value, for which the book value does an ever-poorer job to represent. Based on "look through earning", a term crafted by Buffett initially to more accurately calculate earning power for conglomerates like Berkshire from both wholly owned operating businesses and invested businesses, I estimate Berkshire is trading around low teen price to earning ratio, a very attractive valuation on absolute term for such a safe and great business.

Pinduoduo (ticker: PDD)

Pinduoduo is a new position in "Distressed" category. It is a broken IPO plagued by counterfeit controversies on the surface. The stock dropped 36% from $26.5 on IPO opening to lowest $17.22 in the midst of the PR crisis. However, I believe it is a hidden gem. It is one of the most impressive Chinese companies I have studied regarding management and system factors. Below I will briefly discuss my evaluation of PDD's 5 factors.

Tao: Rarely did I see a Chinese Company CEO writes shareholder letter. Colin Huang made such an attempt to explain his company's mission (where they came from), vision (where they want to be) and value (what's right & wrong)[1]. The core value of "Ben Fen 本分" in some way is very close to "rationality", which is a very attractive trait for business in my framework. I also see a strong customer centric value. Regarding counterfeit, I don't see it is a morality issue for PDD. It is rather a societal value issue of the materialism-dominated country, which may need decades to improve. Through research, I was able to find sufficient indications that PDD had tried very hard to enforce their "10 times penalty" for merchants who violate its counterfeit and copyright infringement policies from early days. In fact, some media narratives in 2017 nicknamed PDD "Faduoduo 罚多多" ("More & more fines", literally), depicting it as an "evil" platform living primarily on fines (in the form of deduction of merchants' compliance deposits) from merchants caught violating counterfeit/infringement policies. Additionally, there were plenty reports on fined merchants filing lawsuits against PDD or even violently protesting to PDD's physical offices. I find it's hard to reconcile these earlier narratives with recent narratives about PDD's negligence, whose creditability and incentive warrants more scrutiny.

Meteorology: Competition is arguably the biggest risk. Pinduoduo grew from a segment overlooked by Alibaba & JD, which is the value-for-money goods for lower classes. Looking ahead, if PDD is planning to grow another 10 folds, there will be much more overlap, both in goods & users, between PDD and the two leading players.

Topography: Rarely did I see an e-commerce business grew registered users to 300 million and annual GMV to $40 billion in its first 3 years of existence. Part of it needs to be attributed to the great infrastructures built in logistics and mobile payment, but PDD should be credited as well for building up some moat to achieve such tremendous growth. PDD stated their mission is to be a combination of Costco & Disney. I think they are close to finishing building an ecosystem which could systematically (rather than by subsidies) facilitate merchandizing goods in their lowest prices, like the "Costco" model.

Commander: Founder CEO Colin Huang has many traits I look for a great commander. I believe he has higher sense of the being, which can be seen from writings on wide range of topics (personal history, philosophy, business & quantum mechanics etc.) from his public blog[2]. Huang claimed he does 2 things in his daily job: 1) instill value & culture to all employees & 2) design processes to handle new things which had no current process to handle. I think Huang is doing everything right and feel very strongly he may be on the way to become the best entrepreneur/businessman of his generation. Of course, that doesn't guarantee PDD would be the business that brings him to that level (similarly it is Tesla, not PayPal that made Elon Musk a global household name).

System: Rarely did I see a Chinese Company lock all employees options up for 3 years from IPO. Like many other traits, this is a manifestation of the company's rational culture. As a Buffett disciple, Huang

[1] PDD IPO Shareholder letter: http://investor.pinduoduo.com/company-information/message-shareholders
[2] Colin Huang's blog: https://colinhuang.com/

appears to see fellow shareholders as partners. Willing to lock employees' stock option for 3 years shows commitment and strong long-term incentive alignment. I also think PDD had some ingenious designs of rules and enforcement regarding counterfeit, which is heavily under-appreciated, if not un-noticed at all, by public. Jack Ma of Alibaba had famously concluded that fining violating merchants is ineffective because the cost of fine is too small compared to the profit of conducting wrongdoing, thus his approach is to kick these merchants out altogether. To significantly increase the cost of violation for merchants, PDD designed the rule of "10 times penalty" to be 10 times of the whole batch of transactions, rather than of individual complaint's amount. Additionally, to effectively enforce the rules, PDD intelligently used merchants' deposits as a cushion for cost of violation, whereas competitors like Alibaba primarily uses such deposits as incentive for merchants to meet transaction volume target (i.e. Alibaba will deduct such deposit if the merchants fail to achieve certain goals). Alibaba's way is equivalent to "death penalty" for all who violates the rule. I believe PDD's way is superior in that it creates strong financial punishment to discourage wrongdoing, while leaving the door open for merchants (especially the ones who have legitimate low-cost structure but lured by quick profits in a bad culture) to go back to prosperous after complying. I believe a structural advantage in such a quasi-legal system will go long way.

In term of valuation, anyone claim s/he can confidently value PDD at this point is lying. I think an appropriate way to see it is a venture capital model. They key assumptions include: potential addressable market, a probability adjusted market share, monetization rate, a mature FCF margin, & a FCF multiple/discount rate. Based on my estimate, what I would say is that this opportunity could have some venture capital investment-like return if they accomplish their vision. But like venture, I believe a prudent size for such opportunity should be small. I was able to build the desired position size below its IPO price of $19.

Others

Different than JD, I remained confident in Tencent's prospect and added on our position opportunistically. I exited Echelon (ELON) as the deal is closed. I exited ATA Online (ATAI) as the special dividend materialized a catalyst for value recognition. I also existed NACCO (NC) & Hamilton Beach (HBB), two positions from NACCO's spinoff last year.

General and Market Commentary

I'm always on lookout for where I could be wrong. When Mr. Market this quarter started to disagree the reality perceived by me for our Chinese related holdings, I did a quick statistical study on the ever correlated movements of many Chinese names[3]. The main question I try to answer is: did I miss any material information related to individual companies' intrinsic value, compared to Mr. Market.

3 URL: https://taovalue.wordpress.com/2018/10/17/quick-review-of-chinese-tech-stock-selloff-what-does-mr-market-know-that-you-dont/

Although each company may appear to have its specific setback, Mr. Market thought the value of many of them similarly decreased about 40% from their recent peak. It's also important to point out, as Chart 1 shows, that his re-evaluation (i.e. price movements) for multiple companies are done in a strikingly synchronized fashion, in the context that dissemination time of each company's new information by nature were different. My interpretation thus is that Mr. Market changed his view not based on company specific information, rather on macro factors.

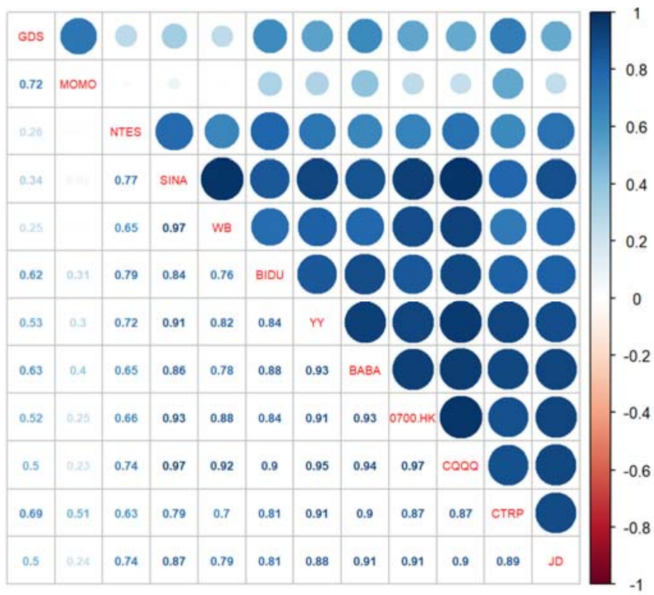

Chart 1: Correlation Matrix of selected Chinese Tech names

It should be noted that I'm not saying Mr. Market is wrong. In fact, judging Mr. Market's reaction to macro information is outside of my circle of competence. As I communicated from the beginning, my research process is a bottom-up one driven primarily by insights of individual company. Thus, a conscious decision that I made is that I should refrain from acting based on the "known unknowable" (in this case, the correctness of Mr. Market reaction to macro information) and should be respectful to "unknown unknown" (in this case, constantly revisiting my thesis to seek any missed information). It implies that I could not persistently time the market, thus should not try to. Our focus has always been identifying a few companies that are undervalued compared to intrinsic value based on conservative assumptions and wait patiently for their prices to converge with their value.

It should also be noted that I'm not saying macro information is unimportant. Any sensible finance professional will tell you the valuation of any risky assets are anchored to long term risk free interest rate, which in term is a function of many macro factors. Our valuation approach certainly took into consideration of it. One of the "conservative assumptions" we adopt is to use long term normalized discount rate (as well as price to profitability ratios) in any valuation we conduct.

Final Note

As I’m writing this letter, US stock market is on its way to the worst month since February 2009 (S&P 500 returned -9.35% as of 10/29/2018). On one hand, I’m respectful to Mr. Market’s presentation of such a low probability event and will try to search for what I could have missed. On the other hand, I’m glad that we had reserved, both voluntarily and involuntarily, some cash dry powder which I could deploy at much better prices if opportunities present. With that been said, I look forward to reporting to you next quarter.