# Tao Value Q4 2018 Letter

January 28th, 2019

For the quarter ended December 31st, 2018, Tao Value recorded a return of -9.07%, compared to -12.74% of MSCI All Country World Index (ACWI). This brings our 2018 full year return to -2.94%, compared to -9.12% of 2018 full year return of ACWI. While it is disappointing the return of 2018 is negative, we achieved better protection of our capital than a broad market index did in bear environment. The past quarter was a volatile and brutal one, stock markets across global kept retreating in panic from their September highs. For our two main exposed markets (US & China), S&P 500 in US dropped by 13.52% over Q4 2018, bringing its 2018 full year total return to -4.65%, whereas MSCI China dropped by 11.28% over Q4 2018, bringing its 2018 full year total return to -19.77%. Considering we have stayed long only and mostly fully invested throughout the year (90+% long exposure on average), I'm pleased that the strategy withstood the first challenge of a bear market.

| | **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% | -7.26% | +3.79% | -5.53% | **-2.94%** |
| **Since Inception (*January 1st, 2017)** | | | | | | | | | | | | | **+24.16%** |
| **Annualized** | | | | | | | | | | | | | **+11.43%** |

*Contributors & Detractors*

| Contributors | | Detractors | |
|---|---|---|---|
| *Position* | *Performance (bps)* | *Position* | *Performance (bps)* |
| Long DVMT | 127 | Long CACC | -161 |
| Long NXRT | 67 | Long GOOG | -158 |
| | | Long YY | -121 |

There were only two positions ended in positive territory in the past quarter. The largest contributor is Dell Technologies Class V (ticker: DVMT) of +127 bps. The second contributor is NexPoint Residential (ticker: NXRT), adding +67 bps.

Dell Technologies Class V (DVMT) closed its complex deal right before the year end, allowing Michael Dell to bring his business back to public. Over the course of last quarter, activist Carl Icahn launched a proxy fight against the deal and sued DVMT's board in Delaware Chancery Court, accusing it of withholding information about the deal. Subsequently on November 14, Dell announced the expected sweetened deal, raising the valuation to $24 billion from $22 billion (that is $120 per share from $109 per share) and cash pool to $14 billion from $9 billion. The deal was eventually approved by shareholders on December 11th and officially closed on December 28th.

NexPoint Residential (NXRT) in the past quarter announced that they had struck 3 acquisitions (two in Nashville & one in Dallas) in Q3 for $130 million, catching up almost the same pace as last year. To fund these acquisitions, NXRT tapped into its short-term credit facilities. With the latest published NAV mid-point at $33.54 per share, the company successfully did a secondary share offering priced at $33 per share to raise about $86 million in mid-November for paying back the short-term borrowings. While it is certainly positive that they still found attractive assets to buy, the price they paid didn't seem to be straight bargains (cap rate of Cedar Pointe was 5.5% & cap rate of Crestmont Reserve was 5.9%). However, management indicated that both properties are located adjacent to existing assets, thus they could have more operating leverage by deploying resources at the same location. I think it is again an indication of reaching a plateau of their fast-growing strategy.

The largest detractor this quarter is Credit Acceptance Corp (ticker: CACC) with -161 bps. It was followed by Alphabet Inc. (ticker: GOOG) and YY Inc. (ticker: YY), contributing -158 bps and -121 bps respectively.

Credit Acceptance Corp (ticker: CACC) and Alphabet Inc. (ticker: GOOG) are our two largest positions, thus it is not surprising that both turned out to be our biggest detractors amid the market-wise correction. CACC returned -12.85% during Q4 2018, however this is not reflective of what happened fundamentally. Following their blasting Q2 2018 growth results (20% unit volume growth & 35% dollar volume growth), CACC reported a softer, yet still strong Q3 2018. Unit volume grew 9% and dollar volume grew 20%. The softening unit volume is mainly due to a decrease of average unit volume originated by new signing dealers. The price at the yearend of $381.76 implied a TTM P/E ratio of 12.4, an undemanding valuation in my opinion.

GOOG returned -13.23% during Q4 2018. The core search business remains as strong as it has been. Revenue growth of Q3 2018 remained 20+% year-on-year. On the product side, its industry-leading strength in AI positions it well for taking major market shares of any future potential new gateway, may it be smart assistant, autonomous car or IoT devices.

YY is another big position in our portfolio and it returned -20.1% during Q4 2018. I think Mr. Market's valuation of it is getting ever more absurd. Without going to the details, YY has about $2 billion net cash on balance sheet, and it earned in past 12 months $504 million profit (although on Non-GAAP basis, main reason is to exclude the new unrealized P/L accounting rule effect on the Huya options sold to Tencent). Mr. Market however thinks this business only worth $4 billion, on an ex-cash P/E ratio of 4! On the business side, it still grew top line by 32.6% in the most recent quarter, albeit with its margin under pressure from both the aging of its streaming business model and new competitions. Since our original large allocation is basically reduced by the market price plunge, I have taken the opportunity to add the position.

*Top 3 Positions*

Our top 3 positions remain Cash, Credit Acceptance (ticker: CACC), and Alphabet (ticker: GOOG). Cash (at 24% of our portfolio) now is our top position. The large cash position was due to 1) corporate action activities (including the cash distribution from the DVMT deal), 2) Stocks holdings value dropped significantly; and 3) a tax harvesting position exit. Without the tax harvesting trade, cash position would be about 18%.

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**Portfolio Updates**

Alliance Data System (ADS)

ADS is a new position which fits both "Distressed" and "Special Situation" categories. ADS at its core is a private label credit card business, which contributes 75% operating income historically. It also has two other businesses – a digital marketing services provider called Epsilon, and a loyalty rewards operation (mainly in Canada) called LoyaltyOne. All three businesses faced some headwinds in recent years. LoyaltyOne was hit hard in 2016 when Canadian Parliament banned expiry of loyalty points; furthermore, many of the credit card business' largest clients who are traditional brick-and-mortar retailers struggled to keep float in recent years; Lastly, Epsilon's business model is in an existential crisis in which ad agencies are gradually disintermediated when the demand (consumer brands) can now deal directly with supply (Google, Facebook, etc.). Amid the market turmoil in past quarter, ADS' stock hit its 5-year low. In late November 2018, ADS announced that its plan to "explore strategic alternative for Epsilon", which is a corporate way of saying "sell Epsilon". Although ADS' core card business may go through a transitional road ahead of it, I think the valuation is now too cheap even assuming the worst-case scenario. I also believe potential divestures could serve as a catalyst for Mr. Market to realize its mistake. Below I will discuss briefly my evaluation of ADS.

Tao: Private label credit card businesses exist to serve merchants in mainly two ways: 1) to save the interchange fees which merchants would have to pay to the consumers' issuing banks; & 2) to collect spending activities of merchants' most loyal, thus most important customers. It is natural to infer that merchants can increase its sales by analyzing the loyal customers activities and targeting marketing to them. This is where a digital marketing services platform, like Epsilon added value historically. A key question at this point is then whether the existential purpose of private label cards is undermined by e-commerce. I think not necessarily, Amazon, for example, use Synchrony Financial, a competitor of ADS, to administrate its private label cards. More transactions will be done in digital way than physical way, but the credit payment processing, in my opinion, is an independent function required by the digital shopping experiences as well. However, the importance of digital marketing agencies like Epsilon could erode significantly as consumer activities can now be collected in greater details (like time spent on each web page, etc.) in digital shopping scenarios, and analyzed better by new generation of ad suppliers (think Google & Facebook) directly.

Meteorology: Traditional brick-and-mortar retailers, who have been ADS' main client base, are under pressure from e-commerce. Among ADS' largest customers, Bon Ton Stores recently filed for bankruptcy, and L Brands (owner of Victoria's Secrets) is yet still underperforming amid a recent rebound of retailing fueled by strong economy. Been said, ADS did realize this secular trend and took actions to pivot to other more prosperous industries. For example, they have moved to hospitality (Carnival Cruise Lines, Wyndham), beauty (Ulta), home (IKEA, Floor & Decor) & e-commerce (Wayfair, Overstock). Street consensus still expect it to grow its book by low double digits rate, which I believe is achievable if the retail side don't deteriorate further.

On the funding side, a rising interest rate environment will push ADS' funding cost higher (thus narrower credit spread for its arbitrage) as it uses primarily securitization, which is a negative factor.

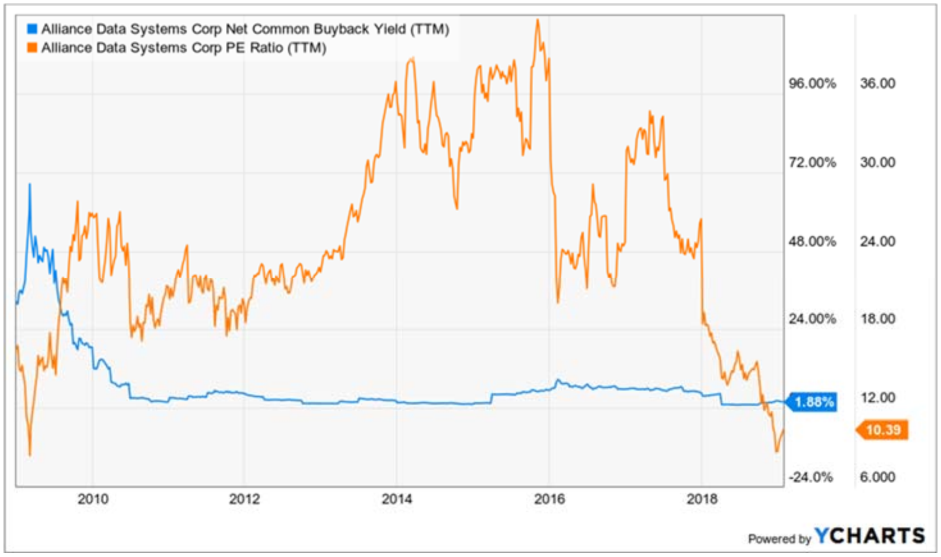
Topography: ADS' card business earned impressive profit historically, indicated by its industry leading average ROA of 6% (a ROA over 4% would be considered good for credit card operations[1]). It is no secret that private label credit card is a lucrative business model. After all, this type of business does a strategy I called "credit arbitraging" by charging sub-prime-like interest rate (usually over 25% APR) on prime quality receivables (with delinquency rate of 6%). I believe the reason why such an opportunity exists is that human behaviorally tends to overlook the small dollar value interest charges without realizing the high interest rates on these small amount loans. I thus believe the ability to consolidate large pool of such high-quality small receivables and do this arbitrage at scale is an established edge for ADS. The next key question is to ask is whether ADS' profit margin will be driven down by competition?

I don't think so. I believe the main source of the moat protecting ADS' profit margin is the switching cost. When merchants have all of payment, loyalty, marketing & customer services integrated with ADS' solutions, it would be an extremely difficult job to switch to another vendor. ADS also intelligently picked a mid-size merchants niche market, where the clients are not too small to be nibble in switching, or too big to attract large competitors like Citigroup or Synchrony Financial. Selling Epsilon may appear an erosion of the switching cost moat, but I think the moat is eroding regardless, due to the disintermediation risk mentioned before. To widen the moat, ADS should explore other value add services to merchants to increase the switching cost.

Commander: As a former banker, ADS' CEO Edward Heffernan seems to have strong capital allocation skills, especially in returning cash to investors via opportunistic share buybacks. Below chart shows ADS' valuation (approximated by trailing 12 months P/E ratio) vs. its same period net buyback yield (a metric basically tells you how much % of the market cap the company bought back). The flipped shape of these two lines during 2009 is an exemplary sign of a great capital allocator who aggressively buys back shares (over 60% of the outstanding shares) when company is deeply undervalued. There are similar negatively correlated periods of time more recently (e.g. February 2016). The 9% buyback yield was sizable, although dwarfed by the 68% buyback yield in 2009 in the chart.

1 Report to the Congress on the Profitability of Credit Card Operations of Depository Institutions. https://www.federalreserve.gov/publications/files/ccprofit2017.pdf

Once ADS sell Epsilon, I would expect the large portion of the proceeds will be used for share buyback if the price stays so cheap, which would be an additional lever to drive per share earnings growth in future years.




Valuation:  Mr. Market has been very skeptical about Epsilon and LoyaltyOne (indicated by the similar P/E ratio it assigned to ADS as to its pure play card peers), thinking the earnings from these two businesses the same as the earnings from card business. This assumption is wrong even without the synergetic effects enhancing the switching cost moat. A divesture or spinoff could prove it.

Given its announced plan to sell Epsilon, it makes sense now to value it as an independent business. Marketing agencies industry recently had quite some M&A activities. One of the largest ones was IPG's acquisition of Acxiom's agency business (AMS) for $2.3 billion, valued at 11.5x of its 2018E EBITDA. CEO of another agency leading player - Omnicom, John Wren commented on the deal that they have also looked at AMS before it eventually bought by IPG. Given the market's warm temperature, I expect Epsilon to be sold at a market multiple, which could be around $5 billion, at 10x of it TTM EBITDA of $483 million.

Mathematically, if a segment is sold for higher valuation than the overall company, the rest part would appear even cheaper. For the rest core card business & the loyalty business, I believe it should be valued higher than its peers for the switching cost moat & management capital allocation skills discussed before. Given Epsilon historically accounted for about 20% of the adjusted EBITDA earning power, I assume the rest businesses produced TTM GAAP EPS about $14 per share. Just giving it a peer comparable of 10x P/E will get us to $140 per share (again this is for the card and loyalty businesses alone). The after-tax cash from selling Epsilon would put the fair value well over $200. If ADS can continue its growth, with some help from opportunistic buybacks, I could see EPS growing by double digits and the stock trading over $300 with a more reasonable multiple in a few years.

Others

I added on Tencent and Berkshire Hathaway and have fully built my intended sizes. As mentioned, I added YY as I remain positive on the business, but the position size got below my intended allocation. We have also made one exit for tax harvesting purpose.

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## Final Note

Different than the market, our portfolio has been quiet in terms of trading activities in the past quarter. During the market turmoil, I have mainly spent my time and resources revisiting each of our holdings. It just happened that my verdicts for most of them were “do nothing”.

2018 overall is a humbling experience. Blessed by the long bull market, young investors started post The Financial Crisis may find 20+% annualized returns are achievable, well, until now. I think the role of luck in investing cannot be understated. Warren Buffett had attributed his success mainly to his luck to be born in United States. Looking back, I think my luck was the strong economy in the past decade of China and United States, both of which gave birth to great new businesses in an unprecedented fast rate. For the foreseeable future, I think both countries will remain the two most dynamic economies with the most industrious talents. I remain excited to keep fishing in these two pools and hope to deliver better than market return through market cycles. With that been said, I look forward to reporting to you next quarter.