Tao Value Q3 2020 Letter

October 26, 2020

For the quarter ended September 30th, 2020, Tao Value recorded a return of +7.08%, compared to +8.41% of MSCI All Country World Index (ACWI). This brings our YTD return to +27.18%, compared to +1.69% of MSCI ACWI.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year /YTD	MSCI ACWI
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%**	**+23.97%**
2018	+2.07%	-3.85%	-3.74%	-0.80%	+4.81%	+2.99%	+2.20%	+4.16%	-0.87%	-7.26%	+3.79%	-5.53%	**-2.93%**	**-9.42%**
2019	+7.68%	+2.62%	+3.19%	+1.46%	-6.54%	+3.28%	+2.40%	-1.53%	+0.43%	+0.52%	+2.42%	+1.25%	**+17.88%**	**+26.58%**
2020	+1.88%	-2.56%	-12.32%	+10.50%	+10.68%	+11.56%	+2.92%	+8.16%	-3.80%				**+27.18%**	**+1.69%**
Since Inception (*January 1st, 2017)													**+86.14%**	**+44.54%**
Annualized													**+18.02%**	**+10.32%**

Contributors & Detractors

Contributors		Detractors	
Position	*Performance (bps)*	*Position*	*Performance (bps)*
Long SE	398	Long GILD	-104
Long 1268.HK	312	Long PDD	-93
Long BEKE	134	Short ACWI	-73

Our top contributors this quarters are Sea Ltd (ticker: SE), Meidong Auto (ticker: 1268.HK) and KE Holding (ticker: BEKE), adding 398 bps, 312 bps and 134 bps respectively. The largest detractor this quarter is Gilead Sciences (ticker: GILD) with -104 bps. It was followed by Pinduoduo (ticker: PDD) and Short ACWI ETF (ticker: ACWI) contributing -93 bps and -73 bps respectively.

As of the end of this quarter, our top 3 positions are Sea Ltd (ticker: SE), Alphabet (ticker: GOOG) and Meidong Auto (ticker: 1268.HK). Collectively, they are 28% of the portfolio.

Sea Ltd (ticker: SE) Based on reported Q2 numbers, Sea did well across the board, beating already high expectation in all 3 business segments. It is evolving into a super app for ASEAN region leveraging its leading positions in all 3 mega trends: gaming, e-commerce & fintech, basically a combined Alibaba & Tencent of ASEAN. Given the strong price reaction, I decided to trim slightly to control position size.

Meidong Auto (ticker: 1268.HK) announced 1H results in early September, revealing impressive progress even amid COVID-19 challenges. During 2020 1H, Meidong maintained high growth (100+% YoY growth across Revenue, Net Profit & Sales Volume compared to 2019 1H). Furthermore, inventory turnover reached another new low – 12 days. I'm truly impressed by its operation efficiency. With the acquisition strategy proven by the Anhui BMW deals, I believe Meidong has unlocked a more certain growth trajectory.

On the detracting side, our largest detractor is Gilead Sciences (ticker: GILD), which dragged 104 bps. Gilead reported a lackluster Q2, falling short of earning estimate by relatively large margin. It however it raised its full year revenue and earning guidance, possibly due to incremental Remdesivir revenue in 2nd half year. Gilead also announced a big acquisition of Immunomedics for $21 billion. Through this acquisition, Gilead will add Immunomedics' crown asset Trodelvy to its oncology pipeline and expect it could be significantly accretive to earnings since 2023. The share price decline might be due to COVID19 themed traders seek exit after a good run. I didn't see changes to our original thesis[1].

Pinduoduo (ticker: PDD) dragged 93 bps this quarter. Investors had high expectation on Pinduoduo coming into this quarter, yet the reported Q2 GMV & revenue fell short of such hype. The stock dropped 14% on the earnings day alone. On business side, management indicated its strategic shift to develop technology solutions for the vast, yet under-digitalized agriculture value chain in China. I think it is a difficult but meaningful problem to tackle.

Portfolio Updates

KE Holding (ticker: BEKE)

KE Holding (Beike), a leading real estate transaction and services platform in China, recently IPO'd with a valuation of $23 billion. Despite the market sentiment upbeat, I see Beike could worth much higher than its current valuation and built a position at cost below $40 per share. As laid out below, my thesis is heavily around the founder CEO Zuo Hui & the culture of the company.

Tao: Beike is a combination of two distinct businesses – firstly an 18 years old household name off-line brokage business Lianjia, and the two years old online platform Beike Zhaofang. The history of Lianjia is a tale about how it single-handedly reshaped the real estate brokerage industry in China. In early years, real estate brokers/agents in China were more of less like "con artists", who would try to rip off both buyers & sellers. Over the years, Lianjia adopted a strategy which charges higher but transparent commission rate (3%) and provides superiors services. It gradually pushed the industry to a modern & dignified position and ultimately captured almost 20% of the existing home sales market. It is a manifestation of its mantra of "to do the difficult but right thing".

As strong as Lianjia, offline brokerage is not the best business from investors perspective. Beike Zhaofang, on the other hand, is a new attempt to solve the next difficult question of the industry – how to make different brokers/agents to work together to bring more value to customers? Building on Lianjia's deep root in traditional brokerage business and wide geographical footprint, Beike launched an Agent Cooperation Network (ACN), consolidating information & processes from various stages of real estate transactions. It created fair allocation of credits for each step, attracting collaboration from

[1] Tao Value 2017 Q3 Letter, p. 4 https://taovalue.files.wordpress.com/2018/04/taovalue_2017_q3_final.pdf

different brokers/agents. I believe this MLS-like platform would be one of the best businesses in the world (huge TAM, low penetration, high scalability & strong network effect), and Beike with its hard earned market position, industry expertise & reputation is poised to capture majority of such value in China.

Meteorology: Real estate transaction market is a RMB 22 trillion market in China, with near 0 "MLS" penetration. Given the attractiveness of a platform business, there have been numerous attempts by other players (e.g. Fang Holdings expanded to offline circa 2016, FandDD's platform for linking developers to consumers) but no home run yet. Why Beike can do differently this time? I think Beike's deep understanding of the industry and its motivation to solve the right, but difficult problem are the key factors. From day one, Beike aimed to <u>empower & incentivize brokers/agents to collaborate</u>, which I think is the right way to evolve itself to a SaaS model. All the failed attempts didn't have this deep understanding, ultimately evolved into ads (taking the easy way out) or commission (being brokers/agents) monetization models. Another recent attempt by Alibaba along with Yiju– "Tmall Haofang" is interesting, but I think Beike still has the up hand for its early start and on field know-how.

Topography: Beike is a market leader in offline brokerage business with wide margin, and the first mover in digital transformation. I believe the Agent Cooperation Network (ACN) is a game changer. In other countries, MLS (multiple listing service) created great value for agents, buyers & sellers. It tends to be a winner takes the most model with strong network effect yet is owned mostly by association or public. I think Beike ACN could have the potential to be the dominant network creating similar and more value for all stakeholders in real estate value chain. A clear extension (since China has less legacy) is to further digitalize mortgage & titling, each being large TAM vertical on its own.

Commander: founder CEO Zuo Hui is the key reason in my investment decision. I think Zuo is a hard-to-come-by mindful entrepreneur. Based on his two fundamental beliefs: 1) one should be honest & 2) business should be profitable, he made a hard decision to adopt a high but transparent commission rate in Lianjia's early days. This decision appeared irrational at the time as Lianjia would not be able to compete with other lower (yet deceptive) commission competitors. Yet it is later proven to be an industry-shaking decision. Zuo wrote a thoughtful shareholder letter in its prospectus, articulating his vision and philosophy. The one key principle is "Do the right thing even if it's difficult". I believe an organization, who validated such principle in building and growing Lianjia, will have ripple effect on value creation in years to come.

Valuation: In the current market condition, I would admit the current valuation is silly to say the least. Even Beike is profitable, the profit mainly comes from the traditional brokerage business. But I think Beike Zhaofang alone could very likely be a $10 billion run rate business one day. I also believe there will be more innovation from Beike in the future creating significant value for all stakeholders.

Slack Technology (ticker: WORK)

We initiated a new position in Slack, who recently is under pressure from Microsoft Teams' fierce competition. I have been tracking Slack since its private days and I think now is a good opportunity to buy. My thesis are: 1) Slack is a fundamentally unique tool creating substantially more value for users (albeit under-monetized) than competitors; & 2) founder/CEO Stewart Butterfield is a mindful leader with proven track record of innovation and pivoting business.

To understand what Slack really is, we need to go back to its birth. When Butterfield and his early partners were busy with their second unsuccessful stint in building a MMO (massively multiplayer) game named Glitch, they were not satisfied with how they collaborate at work using existing tools. Thus, they decide to build an internal tool to get jobs better done with integration of all you need for work, which ultimately became Slack. Microsoft Teams did a decent job in copying it, but it cannot kill Slack. Through channel checks, I found not a single Teams user enthusiastic about it (many use it as a rebranded "Lync", or IM & conference call only, not even workflow integration), while most of Slack users are. I think the users of these two are fundamentally different based on engagements, thus should be valued differently.

Furthermore, I also believe Slack has potential to innovate and pivot, further creating value for stakeholders. Slack is not Butterfield's first major business pivot. Interestingly, during his first unsuccessful MMO game stint, one in-game feature later evolved into the popular photo-sharing website Flickr, which eventually bought by Yahoo!. Building a product on the side later becoming a hit is no easy task, let alone having done it twice. It requires deep thinking about "how to build things right" and extraordinary rationality (think about how you, as a leader, would justify the additional resources while your main product already consumes your team entirely). I believe the new inter-corporation tool Slack Connect is a promising direction, and I expect more of such innovations.

Agora (ticker: API)

We initiated a small new position in Agora, an RTE-PaaS (real time engagement platform as a service) business. Although with a tongue-twisting name, the product can be easily understood as below: If you, as an individual developer, have a good software idea which requires real-time video & audio interaction (e.g. streaming class), you can simply use Agora's tool (and pay them by your users' volume) to code up your product, making it to work in short time (1 week). You are guaranteed by Agora to have your real-time interaction function working satisfactorily. There is an alternative way if you are a company with more resources - to build this real time interaction function by yourself. You might be able to build limited features with 10+ developers working on it for 3 months and you will need to maintain your own servers/network. To maintain and improve this tool, you will also need to dedicate developers & resources going forward. I believe RTE-PaaS has a potentially huge market, as our society is moving towards a virtualized future for which COVID19 gave us a preview. We are probably a few years away from the full fruition of real time interactive virtualization when the value of RTE-PaaS will become more obviously.

I'm also attracted by Agora's founder/CEO Tony Zhao. Zhao grew up as a software engineer, working with Zoom's Eric Yuan in early Webex days, later moved back to China and became CTO of YY (another fellow holding of ours) before he quited and founded Agora in 2014. Zhao is known in the industry for his strong technical aptitude & ability to gather a group of similarly high caliber technical talents. He also seems mindful, in designing Agora's culture. For example, when Zhao founded Agora with some old friends, the first thing they decided is that no matter what exact product they are going to build, they will grand free 10,000 mins for the "developer first" belief. Additionally, Zhao made an unconventional decision on measuring the quality of its product for commercial purpose. While others typically use quantitative measures like latency & downtime SLAs, Zhao decided to use "experience" (i.e. refund if not satisfied) – which appears imprecise and even subjective. But thinking further, I would agree from user's perspective this is the ultimate best, and right measure, which also shows Zhao's confidence in their technology.

<u>Others</u>

We bought Sogou (ticker: SOGO) as a merger arbitrage position as I'm confident in Tencent's commitment. We also fully exited Alliance Data system (ticker: ADS).

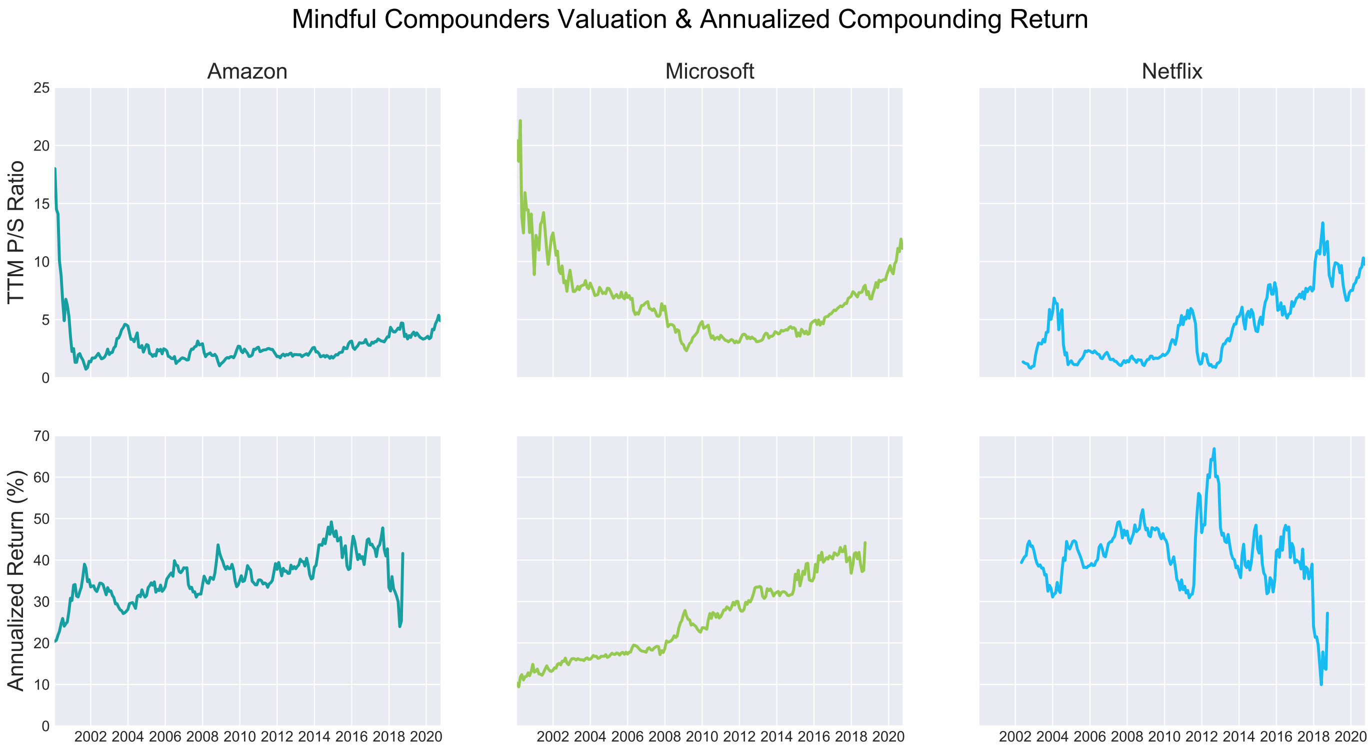
General and Market Commentary

In Search of Mindful Compounders

This pursuit started from studying my own largest omission mistakes (i.e. failed to buy the companies when I could have), namely Amazon, Microsoft (post Satya Nadella), Netflix. But before we dive in, I need to clarify what "mindful compounder" means. I see "compounder" as who persistently create value (not monetary value alone) for all stakeholders across the value chain, and "mindful" is a generalization of many traits I look for Tao & Commander factor, e.g. mission driven, purposeful, rationality, deep thinking & high awareness. (see more in my investment process post[2]). In all cases, I have identified the managers of these companies as mindful leaders yet didn't buy for the fear of market being already efficient in pricing these mega cap stocks.

But how efficient has Mr. Market been in pricing the value of these companies really? Below I draw the monthly time series of valuation (TTM P/S ratio), and annualized compounding return to date (i.e. if holding from that point of time to 9/30/2020). I excluded annualized return for recent 2 years since they are not representative for the short history.

[2] Tao Value Investment Process: https://taovalue.net/2017/07/17/sun-tzus-five-factors-business-analysis-framework/



Source: Tao of Value

One clear lesson to be learn here is that market has been far from efficient in evaluating the intrinsic value of these companies. Taking Amazon for example, the worst time to buy it was in January 2000 when it was priced at 17 P/S ratio, but you would still achieve 20+% annual compounding return if you hold till now. Buying it any other time later than 2004 and holding it till now would give well above 30% annual return! Obviously, valuation still matters, but the worst scenario of 20% is far cry from an efficient market return over 20 years. Similar story happens to MSFT (post Nadella) and Netflix, where you can achieve 30+% annual compounding rate pretty much no matter when you buy. So, the market must have missed something. Luckily, all three companies have long history for me to study patterns that can help identify value earlier.

The "Stumbled-Upon" Quantum Leaps

The first important pattern is none of them relied on a single product/service to achieve the substantial value compounding. As old businesses mature, all these companies in their lives experienced some pivotal "quantum leaps" expanding to new products/services, which disrupted or created a huge market and ultimately contributed heavily to its long-term value. With few exceptions, the leaders later would admit that the leap was not by design, or at least that they didn't foresee the full potential. For example, Netflix had two major pivots from DVD renting, to streaming & to original content. Microsoft also made a major pivot after Nadella took the helm to "cloud & open source first". Amazon's AWS was an internal tool built out of its own frustration of its ability to launch new projects/applications, later became a $40 billion annual run rate revenue monster!

Surrogation Bias & First Principle

All companies try to "leap" too, but more often they end with disappointment. I think what makes mentioned 3 compounders more successful in making such leaps is their mindfulness. Case studies of the failed attempts point to a pervasive, yet understudied bias – Surrogation, whereby <u>the measure of a construct of interest evolve to replace the construct itself</u>. Take Wells Fargo's fake account scandal as example[3], the management initially use cross selling metrics to measure its relationship with clients. However overtime, subsequent executives started to believe the cross selling is the strategical goal (rather than client relationships), leading to the now-infamous mantra – "Eight is great" (to have 8 Wells Fargo products per customer). What made things worse is management started to tie incentives to this single metric for front line bankers, which ultimately led to faking accounts. Such misalignment is detrimental for company value.

On the other hand, all three mentioned companies deeply embed first principle in their operation to overcome surrogation. Amazon provides probably the best example, from Bezos' first shareholder letter, Amazon has been obsessively following a "customer-centric" philosophy and repeatedly use this qualitative principle to guide quantitative measures & decision making. For example, Amazon started very early to not only use GMV & MAU to define their performance, but also added repeating customer orders because it was a better way to measure the stickiness, or value created for customers. Pinduoduo (one of our current holdings) is another example in putting a qualitative Polaris for Social E-Commerce (To focus on user engagement) around any measurements. Chairman Colin Huang in many occasions dismissed sell side analysts' question regarding its ARPU trend & guidance saying "*… raising ARPU is not part of our management's KPI, but I think it will be a natural result as the users' engagement increases over time…*". Also, regarding the measurement of users' engagement, it uses a unique and well-thought-through metric – MAU/Annual Active Buyers. It is like Amazon's idea of repeating customers orders, but more consistent in a normalized % form.

Radical & Prescient Decision Making

Another common theme I observed from mentioned companies is that on top of the first principle thinking, management tend to make seemingly radical decisions later proven prescient. Microsoft's Satya Nadella made an impressive example[4], especially considering his soft-speaking personality (e.g. he's never seen "upset, raising voices or firing off angry email" by colleagues). Yet he demonstrated assertion in many big decisions even early in his tenure as CEO. For example, Nadella decided to write off $7.6 billion from Nokia purchase first year in 2015 and to terminate its Windows division, which was split into Azure & Office divisions in 2016. Additionally, during the agonizing Windows to Azure reorganization (which one executive called "pulling fingernails"), Nadella showed his exceptional ability to make aggressive changes with little drama.

[3] Don't Let Metrics Undermine Your Business, Harvard Business Review, https://hbr.org/2019/09/dont-let-metrics-undermine-your-business
[4] https://www.bloomberg.com/news/features/2019-05-02/satya-nadella-remade-microsoft-as-world-s-most-valuable-company

Netflix's Reed Hastings, a half-mentor of Nadella (as board of Microsoft), is a hallmark of such decision-making ability[5]. Although the decision of pivoting to streaming & original content are both monumental, I think the most radical & prescient decision may be the one he made in earlier year to call off its streaming hardware right before its launch. I was December 2007 and Netflix has been exploring variety of new business models as its legacy DVD renting line matures. A team of about 20 had been working around the clock for years on a project coded "Griffin". It was so close to the launch that marketing materials had been printed, advertisements were being shot, and Foxconn, the manufacturing partner, was ready to kick off production. Yet to the surprise of all the insiders, Hastings decided to kill it (subsequently it was spun off and became Roku). The magnitude of this decision is now much more clear, had Hastings chosen to pivot to the hardware business, they would compete with all other hardware players (TVs, Apple etc.) and wouldn't be able to aggregate the demand side which is a conner stone of its later licensing streaming flying wheel. Roku, even at today's steep valuation, would be worth 1/10 of the current Netflix. According to one inside source, Hastings explained this hard decision in a very simple but vivid way – "I want to be able to call Steve Jobs and talk to him about putting Netflix on Apple TV, but if I'm making my own hardware, Steve's not going to take my call."

Final Note

As long-term investor, if I happened to buy in 1999, I'd want to buy Amazon; if I happened to buy in 2007, I'd wish to buy Netflix. We know the journey won't be linear and there surely will be up & down as companies are destined to evolve. While I'm not sure whether we are in another 1999 or 2007, I try to learn and apply principles proven working through market cycles. I'm confident that the potential mindful compounders I found will create substantial value for us. With that been said, I look forward to reporting to you next time.

[5] https://www.fastcompany.com/3004709/inside-netflixs-project-griffin-forgotten-history-roku-under-reed-hastings