

Tao Value Q1 2021 Letter

April 27, 2021

For the quarter ended March 31st, 2021, Tao Value recorded a return of +3.96%, compared to +4.88% of MSCI All Country World Index (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%	+4.74%	+14.88%	+4.99%	+60.66%	+16.33%
2021	+7.55%	+5.30%	-8.20%										+3.96%	+4.88%
Since Inception (*January 1st, 2017)													+144.46%	+73.42%
Annualized													+23.41%	+13.83%

Contributors & Detractors

Contributors		Detractors	
Position	Performance (bps)	Position	Performance (bps)
Long FUTU	359	Long PDD	-232
Long YY*	178	Long TAL	-123
Long GOOG	148	Long 1579.HK	-91

* Exited position

Our top contributors this quarters are **Futu Holdings (ticker: FUTU)**, **YY (ticker: YY)** and **Alphabet (ticker: GOOG)**, adding 359 bps, 178 bps and 148 bps, respectively. The largest detractor this quarter is **Pinduoduo (ticker: PDD)** with -232 bps. It was followed by **TAL Education (ticker: TAL)** and **Yihai International (ticker: 1579.HK)** dragging -123 bps and -91 bps, respectively. **FUTU & TAL** are new positions that I will discuss in detail later.

As of the end of this quarter, our top 3 positions are **Alphabet (ticker: GOOG)**, **Sea Ltd (ticker: SE)** and **Pinduoduo (ticker: PDD)**. Collectively, they are 27 % of the portfolio.

We exited **YY** after 3.5 years near all-time high. The annualized return (13~%) yet is below expectation, especially compared to founder CEO David Xueling Li's net worth (mainly in YY shares) ballooning from \$1.1B in 2018 to \$2.3B in 2021. On value realization, I think **YY** did a good job, acquiring Bigo, spinning off then selling Huya & selling YY Live to Baidu. But as a minority shareholder, we were treated unfairly. E.g. the Bigo deal (for buying shares from executives including Li) was done by YY stock when the price was severely depressed, causing significant dilution for our ownership. We learned our lessons and will evaluate more rigorously in management's partnership mindset in the future.

On the detracting side, our largest detractor is **Pinduoduo (ticker: PDD)** , which dragged 232 bps, followed by **TAL Education (ticker: TAL)** and **Yihai International (ticker: 1579.HK)** .

Pinduoduo reported a strong quarter, reporting MAU of 720 million, now surpassing Taobao. However, it was overshadowed by a bigger news on Colin Huang resigning from Board and completely disassociating himself from PDD's management & operation. Huang explained in his letter to shareholders that he would start fundamental research initiatives in food science. Although not entirely shocked (as he already stepped down from CEO July 2020), I am surprised by the fast pace of such transition. I remain confident in the organization and the culture Huang built but will monitor it closely.

Yihai International disclosed its 2020 full year results late March, reporting weaker than expected performance mainly due to heavy impact by the pandemic on first party Haidilao's contribution. On the fast-growing third-party business, it still produced strong growth over 50+%. I think the impact of pandemic is behind Haidilao. I also expect Yihai to re-gain its growth momentum fueled by strong third-party innovation & first-party Haidilao expansion.

General and Market Commentary

The past quarter is a challenging one for many Chinese businesses, who got squeezed by both US-China geopolitical stress & Chinese own regulation grip. Even with high hope for the new (and more civil) US administration, the first US-China meeting since the new president started with a very hostile note from both sides. Although no one has the crystal ball predicting how the geopolitical conflict will evolve, I am quite certain that US & China will remain the two strongest economy in the foreseeable future, and that they can both foster great businesses which do not take globalization for granted.

The Case for Investing in Chinese Education Business

Education in China is a unique business. Eastern Asian culture has been glorifying education for thousands of years, arguably since Confucius. In modern China, the College Entrance Examination, or Gaokao in the eve of high school graduation has been the most important days for generations. After all, which college you could go solely depends on what you score in this single test. Sometimes, a 10 points difference (in the context of usually 600-700 points total score, varying by province) could mean difference between heaven and earth in one's life trajectory.

This profound life-shaping implication creates cascade effects on all aspect of the society. For example, parents willingly pay hefty tuition to cram students' nights and weekends with after-school learnings & trainings, hoping to increase the odds to get into a better college/high school. Additionally, properties with good school districts enjoy a large premium compared these without across 1st & 2nd tier cities.

The Gaokao system, although far from perfect, still is believed by majority to be the best talent selection system and remains the most accessible route to change one's fate for unprivileged classes. I could not

imagine if Gaokao is abolished and Chinese universities could start to admit students by discretion, it would be exploited so badly that would make Rick Singer's scheme to look like amateur. Thus, I believe in the foreseeable future, Gaikao will be here to stay, so will be such structural cascade effects.

This leads to the best (or the worst, depending on your view) feature of Chinese education business, which is its strong pricing power given the irrational demands. Basically, any goods or services that can help students increase odds to do better (or can make parents to feel their students would do better) would fly off the shelf. Without a sound regulatory framework, such a market is destined to be flooded by greedy and predatory players. In this sense, strong regulation is a good thing to foster healthy participation of private sectors in education.

It is thus crucial to understand the true intention of the ruling party & regulatory body, which requires going back the history of Chinese private education industry. China firstly opened its door for private sector in Education in the 90s due to lack of state funding, and then in December 2002 published the corner stone law - the "Non-state Education Promotion Law of PRC". Due to the lack of private capital in early days, the namesake law is indeed to promote private sector participation. Subsequently, this law got updated and revised over the years. In the backdrop of more capital flowing in, the 2016 revision started to become more "curbing" than "promoting", so does the 2018 revision proposal. In my opinion, the government got tremendous value from private education and will still need such help, however, it now strives to rule out unfair and predatory players, who put financial results before educational results. I also believe the second, but more important goal is to maintain education's class mobility function (which is a foundation of long-term society stability & prosperity).

With such uniqueness, this market segment appears to be quite inefficient as most investors (especially foreign ones) would turn away from underwriting seemingly unpredictable regulatory risks. When new regulatory changes are looming, as rumors circulated in the past quarter that the 2018 proposal will be finalized and implemented soon, we have seen the valuation of companies across the sector got cut by more than a third. This is a classical case of babies being thrown out with water.

In my framework, the first principle of identifying the best education businesses is to find the best educators. I am happy to report that I have found two strong babies in this round of panic dump. They are **Tianli Education** & **TAL Education**. Both are led by mindful founder/CEO and are delivering best class education experiences to their students, impacting many lives for better.

Portfolio Updates

Tianli Education (ticker: 1773.HK)

Tianli is a new position in “Mindful Compounder” category. It is a leading private K12 school operator in 3rd & 4th tier cities in southwestern China. Helped by the strong tail winds in education sector, Tianli is growing its revenue by 40+% CAGR, mainly driven by new school expansion.

Measured by the % of college acceptance rate, Tianli sends over 70% of its high school graduates to 1st tier colleges, compared to 10~% overall rate in such under-developed regions. This is impressive because Tianli do not strictly select top students in its admission process. Backed by its core educational philosophy & principles, Tianli also proved that it can repeatably deliver such quality education experience to new schools in new regions.

Because of such high reputation, Tianli only expands after invited by local governments. Such invitation also comes with performance-based grant, which Tianli uses to reduce the capital intensity of its operation. On a typical deal, Tianli can get up to 50% of the total investment requirement from such grant, and about 30% as loans from banks, then contribute 20% equity. Such model allows Tianli to earn very high return on equity. To understand the sustainability of such model, we need to make sense of objective of such government grant. High quality K12 schools are very scarce resources, especially in less developed region. Such a school could serve as an anchoring gem in civil planning, retaining & attracting talents, bringing prosperity and lifting the land/property value, which local governments heavily rely on as a fiscal income. To put it simply, government earns generous return both in short term and in long term for such investment. Thus, I believe Tianli’s model is sustainable in long run.

The founder CEO Luo Shi is a very impressive mindful leader. Luo is known to have deep passion about education, and to participate decision making on school level to this day. He also has been advocating creating value for all stakeholders (including shareholders, teachers, government, community, etc.) as an enterprise, a trait I highly value. The fact that Tianli primarily expands in low tier cities also helps promoting class mobility the government deeply cares about.

Since Tianli is still in its early years of growth curve, many new schools are running under capacity and naturally needs time to get to full enrollment. It carries 35 TTM P/E ratio optically, but I estimate it is only about 12 times of full enrollment earnings for all existing & planned schools, with still years of long runway of expansion. I believe it is an attractive price for such a great business.

TAL Education (ticker: TAL)

TAL Education is a new position in “Mindful Compounder” category. It is a leading after school tutoring provider, going through a structural offline to online transition. It was also impacted heavily by the recent looming regulation change related to after school tutoring. On meteorology factor, TAL similarly enjoys a growing spending power of households across the country and has long growth runway. It has

compounded its revenue by 45% over the past last decade. TAL is also undoubtedly the leader in education quality, highly regarded by parents (for its results) and loved by students (for its fun & intriguing learning experiences).

The founder CEO Zhang Bangxin is among the most mindful leaders that I have studied, and is a key reason for me to buy in. Over the years, Zhang had made many seemingly drastic but deeply rational decisions, a key pattern I look for. For example, Zhang decided early on that parents can test attend any class and ask for pro-rated refund anytime, a rare but “right” practice among all after-school tutoring organizations. On expansion to new subjects, he also intentionally took it very slowly because that is the only right way to grow while maintaining high quality education. One famous core value of integrity Zhang instilled to all teachers is that: “Not teaching your students well is equivalent to steal or robbery.” Zhang shows deep understanding of the nature and risks of commercialized education. I believe he has the right mindset and execution ability to lead TAL to do very well under any circumstance.

TAL is undergoing a transition from offline to online (or OMO, offline merge online), accelerated by COVID. This requires heavy investment in technology & infrastructure, leading to a change of its margin profile & profitability. It also faces deep pocket VC backed online-native competitors like Yuanfudao & Zuoyebang. However, I believe that education in its essence is a human (or I should even say “soul”) services which technology helps to deliver, and that TAL’s long time accumulation of know-how and practices will help them succeed through such transition.

Futu Holdings (ticker: FUTU)

Futu is a new “Opportunistic” position. It is an HK based online brokerage & wealth management platform with deep root in technology. Futu sits in the confluence of 3 strong favorable forces of Meteorology, Topography & Commander, yet was underpriced at the time of our entry. In terms of Meteorology, there is a huge addressable market of Chinese domestic middle to upper classes’ wealth being deployed to overseas assets allocation in the next decade. Additionally, the incumbents being disrupted are extremely weak in their digital transformation. On Topography, Futu’s user-centric product design built an intuitive front end and great user experience, while the digital native development framework built solid & reliable back end (including a self-developed order routing & execution system for HK market). This is a rare combination compared to both offline incumbents (who lack flashy front end & UX) & other new online disrupters (who lack solid infrastructure). On Commander factor, founder CEO Li Hua was a Tencent engineer in its early days with deep knowledge in product design and development. Li is said to be a fanatic product manager, to this day still at the front-line, alpha testing any new features. Based on analyses of these factors, I think Futu could compound its revenue at a very high rate with very high certainty and with strong operating leverage, putting our entry price very attractive compared to earning power in 3-5 years. Yet just as we finished building a small position, the price started to take off and more than tripled in a month. When such price action happens, it is obvious that Mr. Market has turned very euphoric to this name. I decided to trim but kept a reasonable position given its growth certainty.

Others

We made below position exits for which I will briefly explain:

- **JOYY (Ticker: YY)** - as discussed before.
- **Slack (Ticker: WORK)** – it is a relatively new position since Q3 2020 yet materialized quickly with the Salesforce acquisition. I decided to sell to fund our new positions.
- **Fu Shou Yuan (Ticker: 1448.HK)** – It is a holding since Q1 2018 yet executed below expectation. I believe the capital will be better deployed at our new positions.
- **China Index Holding (Ticker: CIH)** – It announced a go-private deal in November 2020 with price capped at \$2.32. I decided to sell to fund new positions.

Final Note

While the quarter end performance of our portfolio may seem benign, the time series of it is nothing but. From peak to trough during the quarter, it endured a -25% drawdown. As I said before, when we stay in the market long enough, our portfolio is destined to experience value cut in half, and for multiple times. Rather than worrying about the inevitable, I prefer to spending time studying companies and entrepreneurs. I strongly believe when we hold a set of great businesses bought at reasonable price, the performance will take care of itself. With that been said, I look forward to reporting to you next time.