QUARTERLY COMMENTARY

31 December 2022

Manager Update: January 2023
John Qiu, Founder

In most professional fields being a contrarian is a liability (so please don't use the services of a contrarian doctor or drive across a bridge made by a contrarian engineer – you will probably die), however in the world of investing, it can be one of the few advantages to achieving extraordinary results. Nonetheless, a philosophy is only as good as the intellectual and operational framework in which it's applied. Simply buying hated companies without good reason is a long-term recipe for losing everything and likely far worse than playing centre-back to the investing herd. Furthermore, as a fund manager, executing this type of contrarian-based strategy requires the complete trust and support from one's investor base to buy into storms and maintain holding power. Without it, this strategy could easily become one of buy cheap and sell even cheaper.

The Orlog Capital model was designed with all this in mind. But while it maximises our strategy's ability to achieve strong long-term performance, the obvious limitation is that it won't be suitable for most investors. We are ok with that. Even as we plan to open the Fund to external investors over the next 1-2 years, we are determined not to engage in push marketing and our subscription/redemption terms will remain purposely restrictive (quarterly only dealing, three months in advance redemption notice, one year lock-up). Our investing philosophy requires patient capital and partners with a probabilistic viewpoint of the world. Without these, we cannot deliver.

Our first year of performance was promising and we were quietly satisfied with the 33% net return. Most of the money was made from our long stock picks with only minimal contribution from our short ETF positions. We feel lucky to have started our track record during such extreme market conditions as it provided many incredible opportunities to capture value. Our time and efforts were spent increasing our understanding of individual companies instead of worrying about markets and the resulting valuation-based roadmap guided our decision making during the market roller coaster. Make no mistake, it was tough experiencing double digit negative daily price moves, facing a constant barrage of negative news and opinions and making difficult decisions where to recycle capital. But our work had built strong conviction in various outstanding risk/reward investments and we executed with discipline on our views.

Our Fund remains heavily exposed to China and we expect the end of zero-covid to play a significant role in the earnings growth of investee companies over the next year. We believe the challenging economic conditions of 2022 was a crucible which cleansed a lot of the past excess and debris from the Chinese business system. Like the regrowth after a bushfire, we expect surviving companies to enjoy a period of prosperity due to leaner cost structures, reduced competition and prioritisation of cash profits. The quote: "Hard times create strong men. Strong men create good times. Good times create weak men. And weak men create hard times" comes to mind in describing this cycle. The companies we own are the hardened survivors and this year will begin a new season of spring for their operations.

Within our portfolio we own some deep value investments which require a significant improvement in capital returns policy to unlock value. One of these: Autohome, is interesting given its largest shareholder is Ping An Insurance which has the reputation of being the best insurance company in China and a pioneer in enhancing insurance float returns by investing in equities/alternatives. Given how vocal Ping An has been in calling for the restructure of HSBC, we would expect them to be more active in extracting value from their other investments like Autohome (where both management and the board are Ping An people). If any reader is acquainted with Ping An senior management, we would appreciate them forwarding this quarterly report as a friendly reminder: Autohome is a cash cow sustainably generating RMB2-3bn pa of free cash flows which based on the Dec 30, 2022 closing share price of US$30.6/ADR translates to 40-60% yield on an EV of ~RMB5.1bn! The business is mature, asset light and has no need for the growing net cash pile. It is in Ping An and minority shareholders' best interests if Autohome distributes all excess capital and/or is privatised.

Looking forwards, we see the continuation of uniquely favourable conditions for our style of investing. The Chinese proverb: "muddy waters makes it easy to catch fish" comes to mind. In the past, to us, muddy waters primarily described the market environment for Chinese equities but today uncertainty and volatility is prevalent everywhere. Our research efforts have increasingly turned westwards where valuations have come down significantly due to rising interest rates and a range of fundamental issues. Although flat to tightening liquidity conditions in Western economies makes a meaningful recovery in the near-term unlikely, preparing and buying early is our specialty – ploughing the fields and sowing crops in anticipation of spring. Another major beneficial condition is the deflation in hope driven asset bubbles and capital flows shifting back into fundamental investing based on real earnings. We understand and expect to excel in this investment environment.

An abundance of opportunities is waiting to be discovered and we look forward to curating the best ideas into our portfolio in the new year. No matter how markets and economies change, we will adapt and do what we've always done: maintain emotional equilibrium, focus on fundamental research and capitalise on market mis-pricings. We are confident that outperformance is the natural end product of this process.

For this quarter's stock discussion, we have selected KION.

About KION

KION is a German multinational industrial company providing materials handling equipment and solutions globally. It operates two main businesses: Industrial Trucks & Services (ITS) and Supply Chain Solutions (SCS). The biggest shareholder is Weichai Power (a major Chinese manufacturer of heavy-duty truck engines, powertrains and hydraulics) with 45% share holdings.

<u>ITS</u>

ITS is forklift trucks manufacturing and after-sales services where KION is the second largest globally (~13% market share) and the biggest in Europe. In China KION is the largest foreign player and the third largest overall. The global forklift market is growing at real rate of roughly low to mid-single digits each year (1.5-2x GDP). There is cyclicality in forklift sales related to economic conditions and warehouse capex cycles.

KION owns five different brands covering the entire value spectrum from Low-end to Premium and specialise in electric forklifts which accounts for >85% of units sold. The business is majority premium forklifts which are distributed and serviced via an extensive network of directly owned and exclusive dealers.

New forklifts are sold outright or lease-financed via long term contracts. KION also rents out used forklifts in short-term contracts or refurbishes and sells them. For majority of their premium forklifts, KION is responsible for providing the after-sales servicing.

<u>SCS</u>

The SCS business operates under the Dematic brand and provides material handling automation solutions for clients. These are typically multi-year projects to automate warehouses/factories for clients in a range of industries including e-commerce, manufacturing, logistics, F&B. Dematic designs, manufactures, installs and integrates the hardware and software behind these projects.

The warehouse automation industry is growing quickly at >10% pa over the medium term driven by efficiency demands and rising costs/limited availability of human labour. Dematic is the largest global player in this fragmented industry where the top 3 has <25% market share (and the top 10 <50%).

What Happened?

KION shares peaked in late 2021 at ~EUR104/share as ample liquidity and cheap credit drove a huge boom in warehouse capex (especially by e-commerce players) as well as stock market euphoria. These conditions reversed sharply in 2022 and was further exacerbated by the Ukraine War and zero-covid policy in China. From the start of 2022, KION's operations faced high cost-inflation and supply chain disruptions followed by declining warehouse automation capex later in the year. This caused significant problems such as:

- Historical ITS and SCS contracts did not have inflation protection clauses
- Cashflow was negatively impacted by delays in forklift deliveries and buildup in unfinished trucks inventory

In early April 2022 KION withdrew their FY2022 outlook (issued just one month earlier) and moved quickly to reprice their backlogs, raise forklift prices and wind-down the unfinished trucks inventory. Despite this, their results deteriorated during the year and they posted an operating loss for 3Q22 (the first time in their listed history). The market also become concerned about KION's gearing and if the company was at risk of any covenant breaches.

KION shares started falling from the beginning of 2022 and only bottomed in late September/early October at ~EUR19/share.

What we saw

We started researching KION in July 2022 and had our first discussion with the company in early August. What we quickly grew to appreciate about its businesses included:

1. KION's ITS business seems very similar to John Deere's farm equipment business. The high barrier to competition is in premium trucks where the usage is high and critical to normal operations. In this market customers are less sensitive to price and care more about the reliability, safety and operational efficiency of the forklift. Therefore, brand reputation, strong customer relationships and an extensive sales/support network are essential (repair or replacement turnaround speed). The business is sticky and KION is involved in the entire life-cycle of their product which includes the long duration, high-margin after-sales servicing

2. Dematic is likely to continue benefiting from good long-term secular industry growth and market share gains. We think rising complexity and the multi-year, high investment nature of warehouse automation projects increasingly favours big players - clients require confidence that big automation investments will deliver results (track record), be completed on time and to plan, and supported into the distant future (financial and technical resources). Also, speaking with industry insiders, we understood the sudden inflation and activity downturn was an industry wide issue which caused significant pressure among many small to medium sized service providers. There were also rumours one of the top five players was in financial troubles. We expect to see accelerated consolidation in the coming years with heightened opportunity for Dematic to expand its presence in Europe and China. Future competitive bidding and pricing of projects is also likely to be more rational.

   Lastly, we really like the after-sales servicing part of the business which is high margin and captive (complexity of integration of processes and hardware/software makes it difficult to switch to 3rd party providers). This will grow alongside the pool of installed projects

3. KION's accounting is likely conservative and the P&L understates true cash earnings. We think D&A assumptions are aggressive which is seen by calculating the difference between total D&A and Capex (both PPE and Lease/Rental) over the past seven years from FY2015 to FY2021 which comes to ~EUR1.6bn or EUR230m pa. And this is despite a growing production base and lease/rental forklift fleet. Adding in total non-cash reversals of Deferred Revenue, this comes out to ~EUR440m or EUR63m pa which roughly translates to +20% excess in cash earnings above normalised NPAT

4. The elevated gearing was unlikely an issue. KION had lived through higher levels of gearing with a smaller business in the past (FY2016-2018 post Dematic acquisition). A large part of the debt would reverse as the unfinished truck inventory is wound down and these are all contracted sales. Lastly the forklift financing related liabilities were both maturity and interest rate matched

In our view, KION's business is high quality and management executed optimally in difficult market conditions. Their quick move to implement dynamic pricing of forklifts, inflation protected contracts and repricing the existing backlogs was strong evidence of both the rational competitive environment and company pricing power. We believe the various issues faced by KION in 2022 are temporary and/or cyclical and the business should overcome most of these negative effects by mid-2023 (assuming North America and Europe doesn't experience a significant recession).

Valuation

Our conservative estimate of normalised mid-cycle earnings for KION is ~EUR450m. We believe earnings can compound from this level at a structural real rate of high-single to mid-double digits each year over the medium term driven by: a) mid to high single digits revenue growth and b) margin expansion.

Applying a 12-20x multiple on the EUR450m implies a share price valuation range of EUR40-70/share.

We happily accumulated KION shares in the second half of 2022 at prices below EUR30/share. Today with the share price in the low EUR30s, we still see good value in KION given the quality of the company and promising future prospects.

Portfolio Overview

ORLOG CAPITAL

Top Five Major Holdings (in alphabetical order)	
CNOOC	Oil & Gas Exploration & Production
DADA Nexus	E-Commerce
JD.com	E-Commerce
Sands China	Casino operations
Spirit Aerosystems	Aerostructure Manufacturer

Performance	
Non Annualised Net Returns in US$[1]	
Year to date	33.4%
3 months	24.3%

1. Net of 1.5% annual management fee and 20% performance fee (excess return above 5% hurdle rate and subject to HWM)

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