QUARTERLY COMMENTARY

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Commentary

ORLOG CAPITAL

Manager Update: July 2024

John Qiu, Founder

Today, with the internet and social media just a fingertip away, news is global and 24/7. Most is just white noise to the business of pricing assets but that doesn't stop the finance entertainment industry from repackaging every bit with expert opinions giving them value far beyond their real worth. We increasingly see the phenomena of small price eddies becoming whirlpools as narratives and prices spin out of control, feeding each other in an expanding validation cycle. It gives investors the grand illusion of control over their beliefs and investment actions when in reality, it is just the herd stampeding to the beat of its own hooves. In our opinion, this can be seen in A.I. and Chinese stocks today. Markets and asset prices seem more momentum and narratives driven than they have for a long time.

As a contrarian, fundamental focused investor, this behaviour of markets is both a source of opportunity and a challenge. The opportunity is buying exceptionally cheap stocks while the challenge is not knowing how long and to what extent the negative price vortex could extend. Having the holding power to ignore extended irrational pricing or the guts to buy more, is hard. Holding a strong view that the market doesn't validate for an extended period of time, is one of the most underrated and painful things in investing. Even if that view turns out to be ultimately correct, restless capital has often long deserted the pitch. When I first started in the industry with Allan Gray/Orbis Investments, I would hear war stories on how half the clients left during the two-year build-up of the dot-com bubble as the fund refused to compromise on its value investment approach and follow peers into surging tech stocks. When the bubble finally popped, the fund did extremely well, and capital came flooding back (though never the same capital that left). With the Orlog Capital fund still in the seed stage, we don't worry about capital desertion, but we see similar parallels between that period and now.

Our gravitation towards Chinese equities has been the primary reason for our poor performance. Since the inception of our fund on January 3, 2022, the portfolio weighting of Chinese equities has risen from ~67% to ~95% today. It increasingly feels like we're an alpha fund participating in a beta garage sale. Many high-quality Chinese companies are now cheaper than when I first started investing in the region over a decade ago, despite revenues and earnings that are now multiples of what they were back then! Positive fundamentals are mostly being drowned out by a deafening cacophony of bad China narratives. We aren't shy of backing our highest conviction ideas in size and here we'll look at a snapshot of the value we're seeing through the lens of our top five stocks which account for over 50% of portfolio.

Dada

Dada was discussed in our previous quarterly report and since that time, the stock has fallen further. At the current ~$1.4/ADS, Dada's Mcap and EV is RMB2.6bn and -RMB1.2bn respectively. For a company with RMB3.8bn in net cash and given its cost and operating structure, this makes no sense to us. At its core, an investment in Dada is a bet that it can scale operations to cover a relatively stable fixed cost base where majority of that scaling is dependent on converting and monetising its parent, JD's traffic. External competition plays a limited role in this.

For us, we believe this is more a matter of when, rather than how. However, we think there are many actions that should be undertaken today to improve transparency, corporate governance and accrue value for both company insiders and loyal shareholders. We've written to Dada's board and management with our suggestions and a copy of this letter can be found on our website or here. We encourage other Dada shareholders to also speak up. This is an opportunity to break the negative narrative and create a win-win situation for all Dada stakeholders if the company moves quickly and forcefully on these issues.

Full Truck Alliance (FTA)

FTA is the dominant platform for 3rd party long-haul trucking in China connecting fragmented groups of Truckers with Shippers. By consolidating orders online, FTA's platform offers a superior price and time efficient way to fulfil shipment orders versus the previous practice of offline logistic parks (where Truckers would literally walk around for days seeking and negotiating orders at stalls setup by Agents) and Shippers relying on 3rd party Agents to find Truckers.

We became interested in FTA in late 2021 as its share price progressively declined following the cybersecurity reviews of the company (part of industry wide reviews in the wake of the Didi investigations). The industry had already consolidated around FTA (the result of a merger between the top two players) after years of fierce competition. FTA was still loss making when we started buying shares, but we believed that it was a monopoly provider of a vastly superior solution to an essential service which it could scale and monetise with time (sounds familiar?). By mid-2022 the cybersecurity review had finished and FTA resumed new user signups. Soon after, FTA started rolling out its Commissions model (charging Truckers a small fee on each order) and the combination of traffic and monetisation saw profitability rapidly improve with normalised GAAP OPM reaching 12% in FY23.

FTA is still in the early stages of monetisation and new services rollout, which will continue driving GAAP EPS growth of 30-40% pa over the coming years. The business is asset light with minimal reinvestment needs so free cash flow generation is significant and continuously adding to its substantial net cash position of ~RMB30bn (~50% of MCap) today. It paid its first dividend this year (~2% yield on current price) and we expect capital returns to ramp up. Despite everything, FTA's share price has remained stagnant, and it trades on forward EV/EBIT of low double digits.

JD

We've been longtime fans of JD. For retailing, competitiveness is driven by sales growth pushing economies of scale which leads to better prices, service, variety and ultimately, profitability. JD's financial history below shows its excellence in executing this model and balancing investments back into operations and the consumer with consistently improving profitability. Since its IPO in 2014, JD's revenues have risen 9.4x, its GP is up 12x and margins have been steadily rising with GAAP profitability first achieved in 2019. By FY23, its annual active users had risen to >600m, its GMV was around RMB4trillion and net cash was over RMB140bn.

Despite vastly improving fundamentals, JD's MCap and EV today is only ~RMB300bn and ~RMB225bn – barely changed over a decade. The current valuation translates to high single digit multiple of FY25E normalised GAAP earnings[1] where we believe earnings can continue growing in the teens based on low expectations of only mid-single digit retail merchandise sales growth. The certainty of margin expansion is relatively high driven by the growing % of 3P sales on its platform, further efficiency gains, and reducing losses in its other businesses. JD started returning capital to shareholders from 2020 beginning with share buybacks and then regular dividends starting 2022 (~3-5% yield based on current price).

All Chinese e-commerce majors are arguably cheap and will continue growing from the long-term structural trend of retail sales moving online. However, we prefer JD over the others because JD is structured with less profit layers between the end-manufacturer/brand and the consumer: it owns its logistics and it does 1P (which we think is the most efficient model for high frequency, standardised products). Over the long term, history shows the most efficient retailing model generally wins, and we think JD is one of the likely winners.

JD.com	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
RMB millions				**IPO: May 2014**									
Income Statement													
Total Reported Revenues	21,129	41,381	69,340	115,002	181,042	258,290	362,332	462,020	576,888	745,802	951,592	1,046,236	1,084,662
Growth		*96%*	*68%*	*66%*	*57%*	*43%*	*40%*	*28%*	*25%*	*29%*	*28%*	*10%*	*4%*
Normalised Gross Profit	1,152	3,483	6,844	13,371	21,562	34,536	49,978	64,997	83,599	108,872	129,037	147,548	159,258
GPM	*5.5%*	*8.4%*	*9.9%*	*11.6%*	*11.9%*	*13.4%*	*13.8%*	*14.1%*	*14.5%*	*14.6%*	*13.6%*	*14.1%*	*14.7%*
Normalised Operating Income	-1,404	-1,951	-579	-2,102	-3,128	-2,071	-1,672	-3,553	4,288	10,458	3,345	18,819	28,464
OPM	*-6.6%*	*-4.7%*	*-0.8%*	*-1.8%*	*-1.7%*	*-0.8%*	*-0.5%*	*-0.8%*	*0.7%*	*1.4%*	*0.4%*	*1.8%*	*2.6%*
Growth										*143.9%*	*-68.0%*	*462.6%*	*51.3%*
Normalised Net Income	-1,284	-1,729	-50	-1,296	-2,305	-1,550	-580	-2,531	5,148	10,723	9,447	15,312	24,040
Normalised NPM	*-6.1%*	*-4.2%*	*-0.1%*	*-1.1%*	*-1.3%*	*-0.6%*	*-0.2%*	*-0.5%*	*0.9%*	*1.4%*	*1.0%*	*1.5%*	*2.2%*
Growth										*108.3%*	*-11.9%*	*62.1%*	*57.0%*
Wtd Avg Diluted ADS Out (m)				1,210	1,368	1,426	1,456	1,472	1,484	1,555	1,554	1,591	1,586
% growth					*13.0%*	*4.3%*	*2.1%*	*1.1%*	*0.8%*	*4.8%*	*-0.1%*	*2.4%*	*-0.3%*
Balance Sheet													
Shareholders Equity	**2,783**	**1,665**	**2,067**	**37,498**	**30,541**	**33,893**	**52,041**	**59,771**	**81,856**	**187,543**	**208,912**	**213,366**	**231,858**
Total Cash & Equivalents	6,289	8,257	12,715	29,077	20,644	22,115	34,276	36,298	61,574	146,662	185,331	219,956	190,146
Total Debt	0	867	933	1,891	6,374	20,258	23,807	14,419	10,052	15,791	9,386	42,379	47,000
Net Debt/(Cash)	**-6,289**	**-7,390**	**-11,782**	**-27,186**	**-14,270**	**-1,857**	**-10,469**	**-21,879**	**-51,522**	**-130,871**	**-175,945**	**-177,577**	**-143,146**

2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**		**2024E**
23.14	32.27	25.60	41.42	20.93	35.23	87.90	70.07	56.13	28.89	Share Price (ADRs) US$	26.76
172,744	**277,439**	**253,499**	**392,306**	**211,782**	**363,889**	**891,586**	**692,407**	**615,103**	**323,711**	**Market Cap (RMBm)**	**304,626**
145,558	**263,306**	**251,912**	**382,185**	**190,999**	**315,171**	**777,658**	**553,123**	**497,693**	**244,473**	**EV (RMBm)**	**225,388**

[1] Normalised by adjusting out: Fair value changes on long term investments, Investment impairments, Disposal gains & losses, Gains from sale of development properties, Bitauto/Tuniu traffic revenue, Equity Investee impact (mostly from IPOs of subsidiaries)

Macau casinos: Sands China and Wynn Macau

We've sized up Sands China and Wynn Macau positions again after their share prices fell back to 2022 price levels. Before 2022, the last time they traded at these prices was in 2011 and 2016 respectively. On both a relative and absolute basis, the valuations seem ridiculous given how Macau's tourism and gaming is booming again with the 2024 recovery (vs pre-pandemic 2019 levels) already back to mid-70s % Gross Gaming Revenue, mid-80s % total visitations and +40% growth in non-gaming spend per capita. In 2022, China was still in covid-lockdowns, there was no certainty of license renewal and casino operators were burning cash with historically high levels of net debt.

At HK$16.4 and HK$6.2 respectively, Sands China and Wynn Macau trades on forward P/E of high single digits where earnings is expected to grow at 20-30% pa over the next 2 years. Wynn Macau has already resumed paying dividends and Sands China will likely resume next year. Once they've right sized their debt, we expect their dividends to jump (historical payout >100%) and reach >10% dividend yield based on current price.

Top Five Positions summary

How does the latest China macro datapoint, housing sector update, geopolitics appraisal, etc directly affect these companies? Minimally. Their operations and future profitability are largely independent of any major China macro recovery scenario, and they don't need a big stimulus event. If sentiment improves on China, they'll likely get a significant valuation mean-reversion but regardless, these companies will continue growing their operations and intrinsic value.

Fund Update

Our performance this quarter remains poor at -17.6% YTD and -8.9% (annualised) since inception. Our China tech investments were the main reason for the negative performance but overall, everything in offshore China weakened again after a brief upward spell in May. It feels a bit like fishing where there are more nibbles, but the greater capital shoal is still waiting for price validation and broader narrative changes. Perhaps a trigger event will be when the U.S. eventually cuts interest rates and the equity risk premium gap widens further. At that time, the PBOC will also have more room to stimulate without having to expend as much resources defending the currency.

We sold the last of our Spirit AeroSystems stock in early July and only KION remains of our non-Chinese equity investments. We've tried looking for value elsewhere, but so far nothing remotely compares to the value we're currently seeing in Chinese equities. Interestingly, our bottom-up research indicates an affordability crisis unfolding in the U.S. where consumer goods companies and the residential property sectors are struggling. It feels like the general U.S. consumer is hitting a ceiling on their spending in a period where conditions are at their optimal limits (liquidity/credit, economy, currency) whereas in China, the consumer is hitting a floor on their spending where conditions are at their worst. The contrast is like summer vs winter and grasshopper vs ant. We have no idea what will happen to the U.S. consumer with a weaker dollar and under a Trump presidency, however we're laying the groundwork on quality companies there today.

Our portfolio strategy today is concentrating our investments further in the best-in-class companies with strong balance sheets, dominant competitive positions, improving operational and financial situations and trading at bargain discount prices. We're selling out of companies which are merely cheap but without any strong catalysts for operational improvements or value crystallisation. At these depressed price levels, there is little need to compromise and we want to prioritise investments with inevitability and sell those offering only possibilities.

Our fund today can be summarised as a series of geared bets on the Chinese consumer. These include the biggest brands benefiting from industry consolidation, localisation and premiumnisation. The companies at the forefront of the retail evolution towards lower prices, greater convenience and better service quality. The monopolies over timeless entertainment services. These are companies where stock prices and fundamentals have diverged significantly and where positive fundamental momentum continues to build.

Final Thoughts

We saw a fascinating video by Veritasium on YouTube regarding fluid dynamics[2]. The description of laminar vs turbulent flow behaviour seems very similar to price behaviour where 'energy' is provided by information and capital conditions. Although the general relationship is already obvious, we wonder if it's possible to create a Price Turbulence index (showing the likelihood of price bubble formations) by substituting the factors in the Reynalds equation [3]. The substitute factors could be Flow Rate = information/capital expansion speed, Pipe Width = information/capital volume, Fluid Viscosity = information/capital's inherent value. If a standardised historical index of this type was created, how high would we score today versus past bubbles?

Also, a key feature of turbulent flow is vortices dissipate with time as energy is transferred down to smaller and smaller eddies. The only way to maintain turbulence is to keep providing energy. Looking forwards, the uncertainty in the world could certainty continue providing new narratives but on the capital side, it seems conditions are subsiding (ex. China). Does decreasing price turbulence mean a reset to a more rational pricing environment?

If nothing else, a natural world framework seems like a novel and interesting way to visualise price behaviour.

[2] "Turbulent Flow is MORE Awesome Than Laminar Flow": https://www.youtube.com/watch?v=5zI9sG3pjVU
[3] Re = Flow Rate * Pipe Width/ Fluid Viscosity

Portfolio Overview

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Top Five Major Holdings (in alphabetical order)	
DADA Nexus	E-Commerce
Full Truck Alliance	Logistics
JD.com	E-Commerce
Sands China	Casino
Wynn Macau	Casino

Performance	
Annualised Net Returns in US$[1]	
Since Inception (Jan 3, 2022)	-8.9%
1 Year	-23.7%
Non Annualised Net Returns in US$[1]	
3 months	-11.8%
6 months	-17.6%
Net Returns By Year in US$[1]	
2023	-27.8%
2022	33.4%

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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