QUARTERLY COMMENTARY

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Manager Update: October 2023

John Qiu, Founder

Everyone knows Buffet's famous saying: "be greedy when others are fearful" but majority of people will never practice it – if they did, who would be left to be fearful? The reality is people become more fearful when others are fearful and more greedy when others are greedy. This groupthink behaviour is not surprising given humans evolved as a social species that relied on cooperation to survive. But what worked well thousands of years ago in hunting game and maintaining tribal cohesion, isn't always appropriate in this modern age, especially in pari-mutuel systems such as horse racing and investing. In these situations, when there is widespread consensus on something, it's the popularity of that view that gets priced in which often skews the risk weighted returns away from fair value. This is why the best horses get the worst odds and why professional gamblers bet on winning odds vs recreational gamblers who bet on winning horses.

In financial markets, pricing is a continuous process and the recursive feedback loop between beliefs and price can amplify the impact of groupthink into extreme bubbles and overcorrections. In today's information age, these can take on epic proportions fueled by a constant torrent of news (often subjective) pushed out across social and mainstream media channels. While we've seen this many times during our career, we think the current negative consensus on China and Chinese equities, is among the most extreme. We have yet to meet anyone, domestic or foreign, who is currently increasing their Chinese assets exposure. Because as everyone knows: China's macro economy is bad, consumer confidence is low, geopolitical tensions are high, demographics are worsening, etc, etc. And forefront of all conversations are concerns on a private sector crackdown, real estate crisis and the risk of a Taiwan war. At most, there are a few long-term China bulls waiting on the sidelines for a sign. For us, from a probability point of view, the sign is already here.

It's not that we're optimistic on the near-term Chinese economy, but the common view that "China is uninvestable" has made the risk/reward of many assets too attractive. The table below shows the valuation of our Chinese equity positions (in alphabetical order) as at 2023Q3 period end. We've excluded CNOOC given its cyclical nature, and to protect the confidentiality of the portfolio, we've only disclosed names of past stock writeups. Also, for simplicity and to avoid bias, except for DADA and China Isotope & Radiation, we use market consensus figures rather than our internal estimates.

Name	Est 3Yr EPS CAGR (Low)	Est 3Yr EPS CAGR (Upper)	FY24E P/E	FY24 EV/EBIT
Company A	10%	15%	8.7	7.5
Company B	5%	10%	12.2	3.6
China Isotope & Radiation*	15%	25%	6.4	4.0
DADA*	20%	30%	5.2	2.2
Company C	30%	45%	16.7	10.3
Company D	15%	25%	6.0	6.7
JD.com	15%	20%	8.6	5.2
Company E	15%	20%	11.5	6.7
Sands China	15%	25%	13.3	15.1
Wynn Macau	20%	35%	14.7	15.6
Average	**16%**	**25%**	**10.3**	**7.7**

*Internal estimates. No sell-side coverage of China Isotope & Radiation. DADA is in the early stages of monetisation so both the multiple and earnings growth rate is too high to be meaningful. We've used earnings under normalised margin, and growth rate excluding margin expansion.

The portfolio average valuation of 10.3x forward P/E and 7.7x EV/EBIT is suggestive of traditional industry deep value stocks with little to no growth, earnings challenges and/or financial issues. But that is not what we own. Most of our China investments are fast-growing industry leaders with large moats to competition. The base level of earnings is relatively low (for many companies FY24E still represents a recovery year), and their growth is not primarily reliant on a broader macroeconomic recovery (e.g. expansion of monetisation, structural adoption trends, reversion of consumer traffic post covid, etc). Most are either holding net cash or modestly geared.

Based on 1x PEG, the fair equity earnings multiple for our portfolio is 15-25x. Or from an opportunity cost of capital perspective, the yield on China 10year government bond is ~2.7% and adding an equity risk premium of 3% gives a required equity return of 5.7% or 17.5x earnings multiple. Assuming a fair valuation multiple range of 15-20x, simple algebra suggests a positive EV (expected value) even when the odds of total loss is as high as 33-50%. This risk/reward structure seems more than adequate in compensating for the entire laundry list of risk concerns.

Portfolio Multiple = Fair Multiple(1-X) + 0(X)
X = 1 – Portfolio Multiple/Fair Multiple

where:
X = % chance of China portfolio value equal to 0
Fair Multiple = 15-20; Portfolio Multiple = 10

X = 33% - 50%

Of course, for those investors with an absolute rather than probabilistic view of the world and those with an inherent bias, China today is uninvestable, no matter the price. But to us, these are winning odds. Remember, before 2022 the adolescent versions of these stocks were trading at multiples of their current value and the overall valuation gap between blue chip Chinese companies and their western peers was small to none. Today, we own operationally better companies (leaner cost structures, greater focus on monetisation, less capital destruction risk) at lower prices and in a supportive market environment (rising liquidity, reducing cost of capital, benign inflation, positive risk skew in policy intervention). It shouldn't take much to beat the current low level of expectations.

Rather than extrapolating current conditions indefinitely forwards, history shows stocks markets and economies tend to cycle. Through this, we believe good companies will survive, thrive and have their value recognised eventually.

Our Fund performance this quarter was -5% QTD and -26% YTD. While disappointing, short-term underperformance like this is not unusual. Our contrarian and fundamental investment philosophy means we're usually buying early, and the high conviction/concentrated positioning accentuates the volatility. The majority of YTD negative performance was from the derating of Chinese equities which we estimate caused high-teens negative impact to fund performance, another low single digit decline was from Spirit Aerosystems (SPR), other actions/positions added positive mid-single digits contribution and lastly the side-pocket of assets early in the year caused roughly -10% impact.

Given our bottom-up investment approach, the biggest determinant of our long-term performance is our success at picking a curated collection of non-systematic risk/return factors. Sometimes events work in our favour, such as in 2022 where the energy shortage, Macau casino licensing and China reopening catalysed the value recognition of our portfolio. This year, a few unpredictable negative events and the systematic derating of China outweighed what has been generally good operating results from our portfolio companies.

Market sentiment and volatility are not things we actively aim to control or monetise. We prune our portfolio based on fundamental factors and we believe what we have today is a portfolio delivering 3-5year earnings CAGR of mid-teens to mid-20s % at a valuation of high single digit to low double digit multiple of normalised earnings. At the minimum, our research gives us confidence in the value accretion from portfolio earnings doubling over the next 3-5years. We expect to realise 50-100% gains eventually from valuation re-rating (fair value multiple of 15-20x earnings), though when and how depends on the swings of the market which is as capricious and volatile as the moods of the sea.

The discipline (and art) of selling is usually driven by opportunity cost considerations but occasionally we are forced to evaluate if we've made a mistake. Given our Fund's contrarian philosophy and concentrated positioning, this aspect is particularly important. For this quarterly stock writeup, we revisit our SPR thesis, a top five position that has suffered multiple setbacks this year.

Spirit Aerosystem (SPR) thesis revisited

SPR has had a terrible year. In April it notified Boeing of a quality issue with some of its vertical fin fittings on the B737, in late June workers went on strike for two weeks to negotiate better pay and in late August it found improperly drilled holes in some of its B737 aft pressure bulkheads. The stock price has similarly been on a rollercoaster starting from ~$30 at the start of 2023, rising to a high of $39 in early February and falling successively lower with the unfolding events to as low as <$15 by mid-September before recovering some ground since. The current price level is similar to the lows experienced in 2020 when B737 production was suspended and global travel was severely disrupted by Covid.

As we understand it, the primary reasons for the stock decline relate to concerns on earnings and free-cashflow impact from:

1. B737 manufacturing issues
2. Continuing losses on non-737 programs
3. Inflation and supply chain pressures
4. High level of debt

Recall the original thesis (outlined in our [2022Q2 quarterly report]) was based on:

1. Commercial aircraft remains a duopoly between Boeing and Airbus
2. Aerostructures is a high barrier business in which SPR retains exclusive, long duration supply contracts on the flagship products from both Boeing and Airbus
3. SPR's cash cow, the B737, would eventually return to service and this production recovery would drive the mean reversion in SPR earnings

Despite the negative events of 2023, we believe the key aspects of the main thesis remain intact. We think:

1. The B737 production ramp up is delayed but not derailed. Production will ramp to 42 shipsets/month by Dec 2023/early 2024; mid to high 40s in 2024; and 50s by 2025. Probably 1/2year delay vs prior expectations
2. SPR remains key to Boeing and Airbus supply chains. They've continued supporting the company with further interest free advance payments this year
3. Demand for commercial airplanes greatly outstrips supply and with a large backlog of orders, Boeing and Airbus are doing all they can to ramp production
4. The B737 manufacturing issues have no flight safety concerns and limited one-off financial and operational impact. The total vertical-fin repair bill is $40-80m (aft bulkhead repairs cost unknown but probably similar) and won't severely disrupt the B737 ramp up schedule
5. The new four-year wage agreement adds ~$80m pa of additional costs (backend weighted)
6. The non-737 programs are a long-term problem but the accounting losses look worse than their actual impact on cashflows. The losses taken today are accounting provisions based on future estimates of inflation, production rate, facilities utilization, etc with many non-cash related costs (e.g. depreciation)

Given SPR's supply chain importance we believe it is in Boeing and Airbus's best interests to see the company healthy and operating sustainably. The bond market shares this view and despite the operational hiccups and a high net debt level of ~$3.5bn, SPR bonds trade close to par value. This gives comfort SPR can

successfully rollover the next debt due of $1.2bn 2025 bonds and at a reasonable rate (currently the implied yield of their bonds is 7-9%). Additionally, we think there is some chance the non-737 programs can be renegotiated on better terms.

As we see it, SPR has lost -$50-150m in one-off costs from the B737 repairs, inflation has added $100-200m pa of additional costs and the B737 production timeline has been delayed by half a year. As a result, our original estimates were too rosy and we think a more realistic expectation for SPR is $0-100m NPAT in FY24E and $300-450m in FY25E. Based on FY25E earnings and 10-15x forward multiple, we get a valuation of $3-6.7bn MCap or $29-65/share which equates 61-260% return (using $18 price).

While this is significantly below our original estimate of $52-97/share, we believe the primary drivers of the original thesis remain intact. We understand the reasons for the value decline (some temporary in nature) which we accept as an unfortunate but normal part of executing industrial turnarounds. And unlike other turnaround cases, we think there is a high degree of inevitability in this situation. Lastly and crucially, we believe SPR remains a company where the absolute risk of loss remains low.

We think the stock price has fallen far more than the actual intrinsic value of the company and therefore we added to our position.

Portfolio Overview

ORLOG CAPITAL

Top Five Major Holdings (in alphabetical order)	
CNOOC	Oil & Gas Exploration & Production
DADA Nexus	E-Commerce
JD.com	E-Commerce
KION	Materials handling
Spirit Aerosystems	Aerostructure Manufacturer

Performance	
Annualised Net Returns in US$[1]	
Since Inception (Jan 3, 2022)	-0.7%
1 Year	-8.0%
Non Annualised Net Returns in US$[1]	
Year to date	-26.0%
3 months	-5.0%
6 months	-21.7%

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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