

# NORDSTERN CAPITAL

## Partnership Memo: 2<sup>nd</sup> Quarter 2021

New York, July 16<sup>th</sup>, 2021

Dear Partners and Friends:

The **NORDSTERN CAPITAL** partnership account returned **+3.4%** in the second quarter and **+13.4%** for the first half year, while the S&P500 index increased +8.5% in the second quarter and +15.3% in the first half year.

### Digital China

*“the United States is continuing to inject cash to the rest of the world [...]. Have we all thought about the consequences that will happen next? [...]. A new financial system is the way of the future. Whether we like it or not, it will be formed.”*

- Jack Ma, Oct 24, 2020 (translated Bund Finance Summit speech)<sup>1</sup>

If we want to invest into the digitization of our future, it is essential, at the very least, to study China. We noticed explosive growth rates in US-fintech, for instance in Square's CashApp usage, prices of cryptocurrencies, payment volume through Stripe or transactions on Robinhood. The desire for cashless payments in general accelerated in the US last year. However, let us contrast our recent fintech advancements with the already cashless society of China.

### Mobile payments volume in billion dollars

	*USA \$bn	#CHINA \$bn
2017	219	31,316
2018	336	42,809
2019	493	53,565
2020	757	66,691

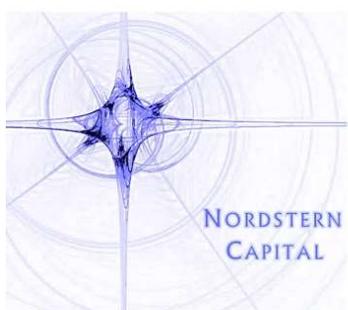
\* US: proximity mobile payments (emarketer.com) + zelle, cashapp, and venmo payments (businessofapps.com)

# China: data from People's Bank of China (PBOC). USD to RMB conversion rate of 6.48 was used.

Mobile payments in the US are growing faster now. However, the US is probably a decade behind China.

China is cashless. China is digital. If you get a utility bill, take out your phone and scan the QR code. Paid. The same applies for corporate money transfers. No online banking, no login, no forgotten passwords, no typing, no waiting, no calling... let's not even speak of having to walk into a bank branch 'to initiate a wire' (a 'wire'? hello? please excuse that I have to laugh...) and paying a horrendous toll to the bridge troll of this stone age technology. Money orders, paper checks, cash counting...you won't find it in China. Waiting three days for deposits to 'clear' in an account? Not in China. Press the button...bam...done.

<sup>1</sup> <https://interconnected.blog/jack-ma-bund-finance-summit-speech/>



# NORDSTERN CAPITAL

In the Western hemisphere there is nothing even remotely comparable to WeChat or AliPay, therefore it is difficult to grasp for anyone who has not seen 'the other world'. WeChat and Alipay together process more than 90% of all Chinese mobile transactions<sup>2</sup>.

There are countless implications. As for another example, take a Chinese farmer, a street vendor, or an underbanked member of society. For financial inclusion he just needs to get a phone and use WeChat or AliPay, print out the QR code...bam...his shop can accept payments and he is in the system. He can make transactions, build a history, qualify for instant loans, mortgages, make investments, buy insurance, manage his inventory...He doesn't need a POS machine, doesn't need to upgrade or service any devices, doesn't require card swiping, PIN, NFC, or any of such technologies or separate hardware.

Financial inclusion in the US in contrast is still an issue. According to Square, 33% of Americans are underbanked<sup>3</sup>. The recent success of CashApp and its no-questions-asked debit card is, in parts, based on offering a solution to those Americans. The CashApp debit card has no recurring costs for Square. Traditional US banks are paying \$36 a year per bank account just for infrastructure services to FIS, Fiserv, Jack Henry and the like and that doesn't include any of the bank's labor, real estate or overhead costs.

## Digital Currency

*"The West is still using QR codes totally wrong. A QR code on a restaurant table that opens the menu is not really what we want. A QR code can be unique to the table and allow food ordering directly to it"*

- Tobi Lütke, Shopify CEO<sup>4</sup>

While the West is figuring out how to use QR codes, so far merely to open internet links, China is already launching the next level of fintech: its central bank digital currency (CBDC), called DC/EP.

DC/EP is a blockchain-inspired encrypted token that registers the entire transaction history: timestamp, location, amount, and every owner's identity. A main feature is that transactions do not require network access, just like physical cash doesn't. Oddly enough, the DC/EP adds a level of anonymity to mobile payments, since only the Chinese central bank can decrypt the owner's identity. Currently, AliPay and WeChat require identification through social ID, facial scan, and phone number, and collect a plethora of user information from every mobile transaction.



Image: kr-asia.com

*"The most profound innovation inherent in CBDCs is that you can pay electronically without using a third-party intermediary like a bank or credit card"*

- Richard Turrin, in his highly recommended book Cashless<sup>5</sup>

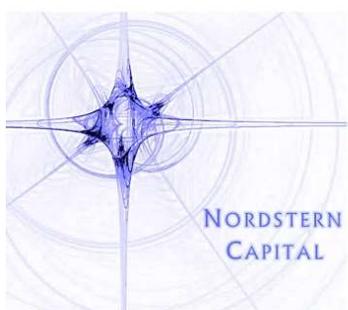
It should be obvious to everyone how disruptive this technology is or would be/will be in the West.

<sup>2</sup> <https://www.americanbanker.com/news/why-chinas-mobile-payments-revolution-matters-for-us-bankers>

<sup>3</sup> <https://squareup.com/us/en/press/credit-karma-tax>

<sup>4</sup> Twitter post

<sup>5</sup> <https://www.amazon.com/Cashless-Chinas-Digital-Currency-Revolution-ebook/dp/B0925JY69H>



# NORDSTERN CAPITAL

It is a stated goal of the Peoples' Bank of China (PBOC) to break the monopoly of the US dollar and to internationalize the Chinese currency. The proposed way forward for the DC/EP is to start replacing the US dollar in cross-border trade with China. The digitized currency allows for Ethereum-like smart contracts and thus might facilitate DC/EP-based international trade through incentives such as targeted preferential exchange rates, trade loans, expedited customs clearing, etc.<sup>5</sup> In times of unhinged dollar printing and inflation, it does not require much fantasy to imagine that some countries might pick up the offered benefits of using DC/EP instead of US dollars. For starters, the central banks of China, United Arab Emirates, Hong Kong and Thailand are joining forces on a CBDC cross-border payments bridge between Asia and the Middle East<sup>6</sup>. It is noteworthy that such new digital trade platforms (the 'digital silk road') offer for the first time a viable alternative to the dollar dominated SWIFT network. This cannot be good news for the world's current reserve currency<sup>7</sup>.

Recently, the Bank of International Settlement BIS, the central bank of central banks, stated that the time of CBDCs has come and that 56 central banks around the world are already considering CBDCs<sup>8</sup>. At the very least, a US dollar-based CBDC would save tremendous costs (at the expense of payment processors like banks, PayPal, Visa, etc.), improve financial inclusion of the underbanked, and provide more data, capabilities, and power to the FED. Let us wager a guess whether a US dollar CBDC is coming sooner or later...

## Digital Regulation

While CBDCs might be the big topic of tomorrow, the headlines of today center around the recent tech regulation in China.



The most recent example is Didi Global's IPO. Just days after going public in the US the Chinese regulator demanded that WeChat and AliPay pull Didi's ride hailing apps from their platforms. I hear lots of rumors and explanations as to why this is/was happening... However, after listening to the insiders of my network, I believe that nobody can predict with confidence what the current regulations mean for the future of Chinese Big Tech.

What is pretty obvious at this point, however, is that the Chinese government did not torpedo the Ant Group IPO as a sole vendetta against Jack Ma. All Chinese (Big) Tech firms are affected by various new laws and regulations. The Chinese government seems to believe that new anti-monopoly and data-security laws will help the country in the long run, even if these measures inflict short-term pain. Plenty officials in the US share the concern about the overwhelming power of big tech companies.

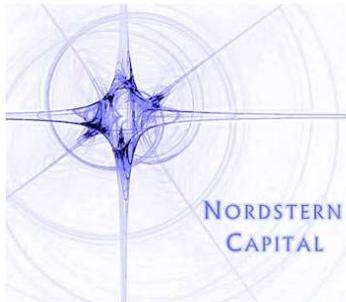
What must be recognized is that China quite recently went through a major disaster with unregulated P2P loans. The Chinese government acknowledged that retail investors lost \$115bn investing in P2P loans and that 42% of all P2P lenders stole the money and basically ran Ponzi schemes<sup>5</sup>. Investigations and arrests

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<sup>6</sup> <https://forkast.news/central-banks-bis-cbdc-bridge-asia-middle-east/>

<sup>7</sup> <https://forkast.news/video-audio/part-ii-the-new-silk-road/>

<sup>8</sup> <https://www.kitco.com/news/2021-06-23/BIS-backs-central-bank-digital-currencies-Their-time-has-come.html>



# NORDSTERN CAPITAL

are still ongoing, e.g. in September 2019 with a 15 year sentence for billionaire Dai Zhikang who ran one of these frauds<sup>9</sup>.

Banks in China are just as restrictive in lending to small businesses as banks in the US. P2P loans were supposed to fill that void, but instead crashed and burned. Enter Ant Group and AliPay. Utilizing its vast treasure trove of data and its supreme AI and analysis capabilities, Ant Group took over in facilitating unsecured personal and SME loans with great success. Ant Group could offer much better customer behavior predictions than any bank. Ant Group offered its vastly superior credit analytics for a fee, while 98% of the actual money for the loans ultimately came from the banks.

In the aftermath of the Chinese P2P credit bubble, the Chinese government saw an issue with the loan facilitation part of Ant Group's business and believed that it should be subject to certain financial regulations including the requirement to hold 30% on the loan value as a reserve requirement.

From a regulators point of view, with stability of the financial system in mind, the new rules intuitively make a lot of sense. The formulation of the microlending laws has been ongoing since 2017<sup>10</sup> and was not a knee-jerk reaction on some speech from Jack Ma. Kevin Xu, founder of the Interconnected blog, suggests that Jack Ma might have known what kind of regulations were coming and that those rules would significantly impact Ant Group's value<sup>11</sup>. He might have used the speech as a final attempt to turn the regulations around. This scenario makes at least as much sense to me as the click-bait of western newspapers feeding the popular narrative of big bad China. The recipe on how to deal with those headlines and articles comes from the teacher himself:

*"If we always repeat the language of others, discuss topics defined by others, we will not only be lost in the present, but also miss the future".*

- Jack Ma, in his speech that according to some pundits derailed the Ant Group IPO



**Digital Gi-ANT**

Instead of partaking in any speculations let us look at the underlying business. Ant Group started in 2004 as a payment processing tool to enable Alibaba's e-commerce, delivering on its mission: *"to make it easy to do business anywhere"*. The following table provides a glimpse into its scale today.

## Payment Processing Infrastructure

	Transactions per second
Visa Network#: average	1,700
Visa Network#: peak processing capacity	56,000
Alipay 2020 Single's Day###: actually processed	583,000

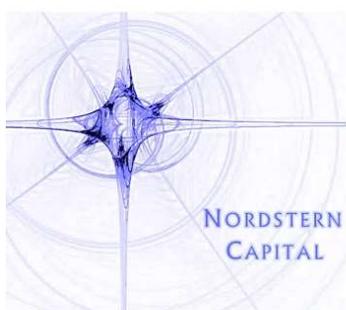
# [usa.visa.com](https://usa.visa.com) and [www.techinasia.com/seeking-solution-blockchain-reach-visas-scale](http://www.techinasia.com/seeking-solution-blockchain-reach-visas-scale)

## <https://asia.nikkei.com/Business/Retail/Alibaba-s-Singles-Day-sales-set-record-74bn-with-help-from-livestreaming>

<sup>9</sup> <https://sg.news.yahoo.com/founder-shanghai-investment-firm-zendai-055429047.html>

<sup>10</sup> <https://www.wsj.com/articles/china-tightens-rules-on-microlenders-1512131146>

<sup>11</sup> <https://interconnected.blog/jack-ma-p2p-lending-responsibility-legacy/>



# NORDSTERN CAPITAL

Alipay, which is mostly free and charges a 0.1% transaction fee only for withdrawals greater than about \$3,000<sup>12</sup>, can process more than ten times as many transactions per second than the entire global Visa Network, which charges between 1-3% interchange fees. Alipay is thus >10x better for >10x less!

Digital Payments today is Ant Group's second largest revenue stream with about 36% of revenues. The largest revenue contributor is CreditTech (the lending business) with about 39% of revenues<sup>13</sup>. Both revenue streams are troubled:

First, even though payments through AliPay are mostly free, the new DC/EP will allow for a digital payments alternative that will be completely free under any circumstances. Therefore, over time the ability for AliPay and other wallets to charge for payment services should erode.

Second, the requirement to reserve 30% of every loan facilitated by Ant Group will severely reduce CreditTech's profitability and growth prospects.

Accounting for that, sell-side analysts reduced Ant Group's valuation estimates from \$320bn to \$120bn<sup>14</sup>. However, aside from the unquestionable impact of the above developments on Ant Group's immediate revenue streams, one might want to keep in mind what the underlying basis for Ant Group's business is:

Alipay is one of two true super-apps in China with more than one billion users and two million 'mini programs'<sup>13</sup> which are launched through its ecosystem. Any Western company, be it Google, Facebook, or Amazon can only be jealous of Ant Group's platform! And that has not changed one bit by any of the recent regulations or whatnot...

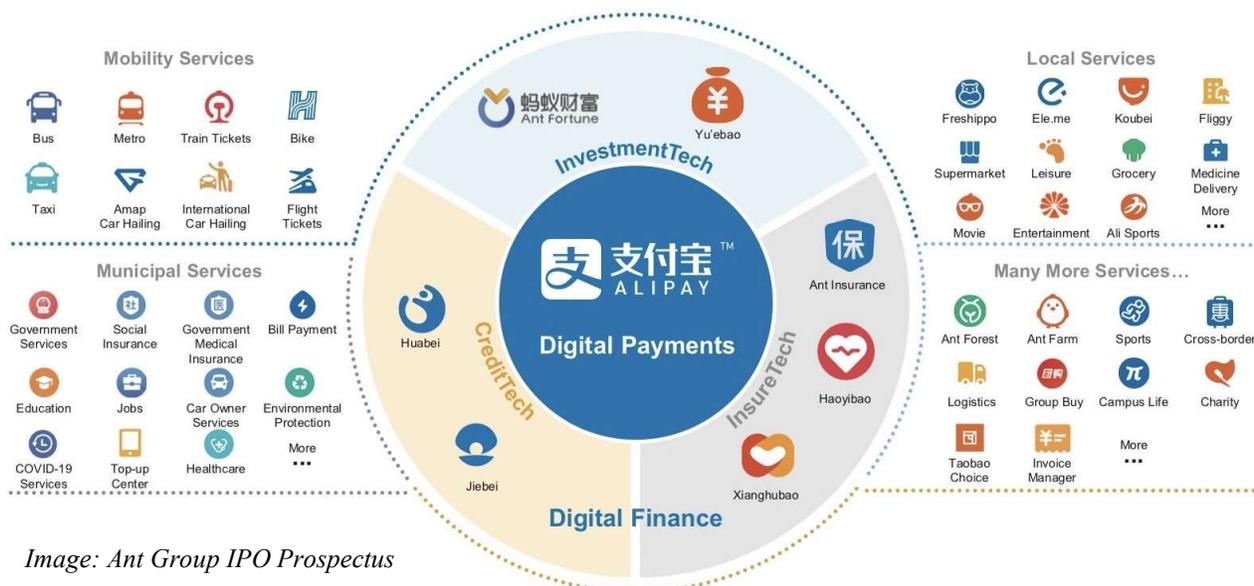
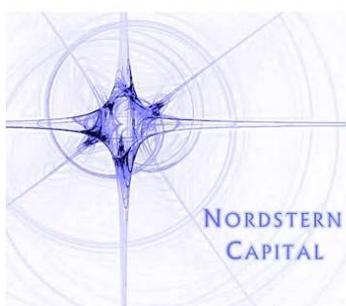


Image: Ant Group IPO Prospectus

<sup>12</sup> <https://sampi.co/alipay-payment/>

<sup>13</sup> Ant Group IPO Prospectus

<sup>14</sup> <https://www.pymnts.com/news/ipo/2021/ant-could-go-public-by-year-end-with-valuation-slashed-60-pct/>



# NORDSTERN CAPITAL

## Alibaba Group Digital Life 阿里巴巴集团

Alibaba is the operating system of Chinese life, the one-stop-shop for services bridging digital life to physical world. Tab your phone and Alibaba fulfills your wish: from garbage removal to cloud computing.

Alibaba's business is so vast that it would take several books to describe. I spare further attempt and point to the sell-side consensus that projects a 23% revenue compound-annual-growth-rate over the next three years. Considering today's share price, Alibaba would trade at 14-times earnings three years out.

Alibaba and its various affiliates made thousands of investments in other companies. At the minimum, the liquid net worth of those investments alone is worth a quarter of Alibaba's current market cap.

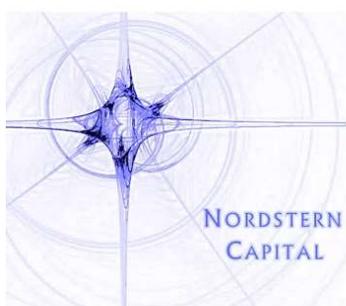
### Alibaba Group: (Semi-)Liquid Assets

	Status	Valuation in \$bn	Alibaba Ownership	Value to BABA in \$bn
Net Cash		47	100 %	47
Shares	Listed Companies	45	100	45
Ant Group	IPO expected	120	33	40
GoTo	Upcoming IPO	38	13	5
Megvii	Upcoming IPO	4	72	3
SenseTime	Upcoming IPO	12	?	?
NetEase Music	Upcoming IPO	7	11	1
Huitongda	Upcoming IPO	4	19	1
BigBasket	Upcoming IPO	2	29	1
Qingci Games	Upcoming IPO	?	5	?
Swan Daojia	Upcoming IPO	3	?	?
AliExpress Russia	IPO expected	3	48	2
SouChe	IPO expected	3	34	1
Xiaohongshu	IPO expected	10	?	?
Magic Leap	IPO expected	10	?	?
Zuoyebang	IPO postponed	10	?	?
LinkDoc	IPO postponed	2	5	0
Qiniu Cloud	IPO postponed	?	18	?
<b>TOTAL</b>				<b>145</b>

This list excludes hundreds of other Alibaba investments. The list also excludes billions of dollars invested into the operating businesses, e.g. the recent creation of the Life Style Services segment<sup>15</sup> (Fliggy, Amap, ele.me, Koubei), as well as operating acquisitions such as the recent \$1.4bn deal to ramp up its ownership in Suning<sup>16</sup>.

<sup>15</sup> <https://www.alizila.com/alibaba-creates-lifestyle-services-division-and-announces-management-changes/>

<sup>16</sup> <https://www.scmp.com/tech/big-tech/article/3139954/chinese-tech-giants-bail-out-suningcom-us14-billion-government-backed>



# NORDSTERN CAPITAL

The above assumes the current sell-side valuation of \$120bn for Ant Group. Notwithstanding, Ant has an impressive slate of investments itself:

## Ant Group: (Semi-)Liquid Assets

	Status	Valuation in \$bn	Ant Group Ownership	Value to Ant Group in \$bn
Net Cash		16	100 %	16
Shares	Listed Companies	2	100	2
PayTM	IPOing...	30	30	9
Zomato	IPOing...	9	17	1
Bukalapak	IPOing...	6	49	3
KakaoPay	Upcoming IPO	11	44	5
Hellobike	Upcoming IPO	5	36	2
Snowball	IPO postponed	1	25	0
Klarna	IPO expected	46	1	0
Mynt (GCash)	IPO expected	1	40	0
TOTAL				38

Some pundits argue that Alibaba's value is zero regardless, because the Chinese government is going to seize it all. While I cannot predict what the Chinese government will do, I think this opinion espouses a Western mindset that does not fully comprehend China. The Chinese government's central goal is to make China the most powerful and wealthy country in the world. We may not agree with the Chinese government's way of pursuing its goals, but that is another matter. I would not be surprised if the future will demonstrate that the Chinese government is in strong support of Alibaba, considering China's ambitions and what Alibaba is building to empower them, e.g. with eWTP<sup>17</sup>, Trusple<sup>18</sup> and AntChain<sup>19</sup>.

## Tencent 腾讯 Digital Buffett

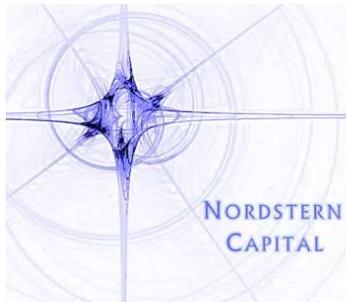
While Alibaba prefers to acquire and centralize, Tencent's general capital allocation strategy is to invest and decentralize. As with Alibaba, Tencent's ecosystem is so vast that it deserves several books.

Sell-side consensus projects 20% revenue compound-annual-growth-rate (CAGR) over the next three years for the operating business. Considering today's share price, Tencent would trade at 21-times earnings three years out. This does not sound demanding for a dominating super-app ecosystem. However, the even greater long-term superpower of Tencent might be found in its investment prowess.

<sup>17</sup> [https://www.youtube.com/watch?v=QSQwzCFu4\\_M](https://www.youtube.com/watch?v=QSQwzCFu4_M)

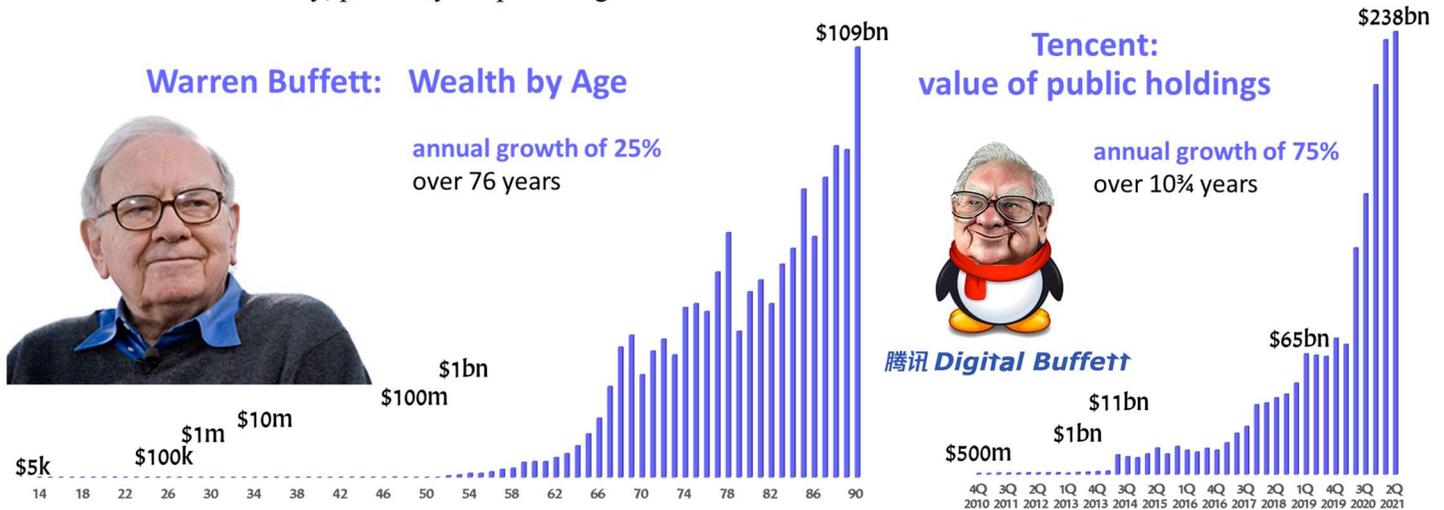
<sup>18</sup> <https://www.youtube.com/watch?v=5GpYImM10cA>

<sup>19</sup> <https://www.youtube.com/watch?v=zytx-M5dIB0>

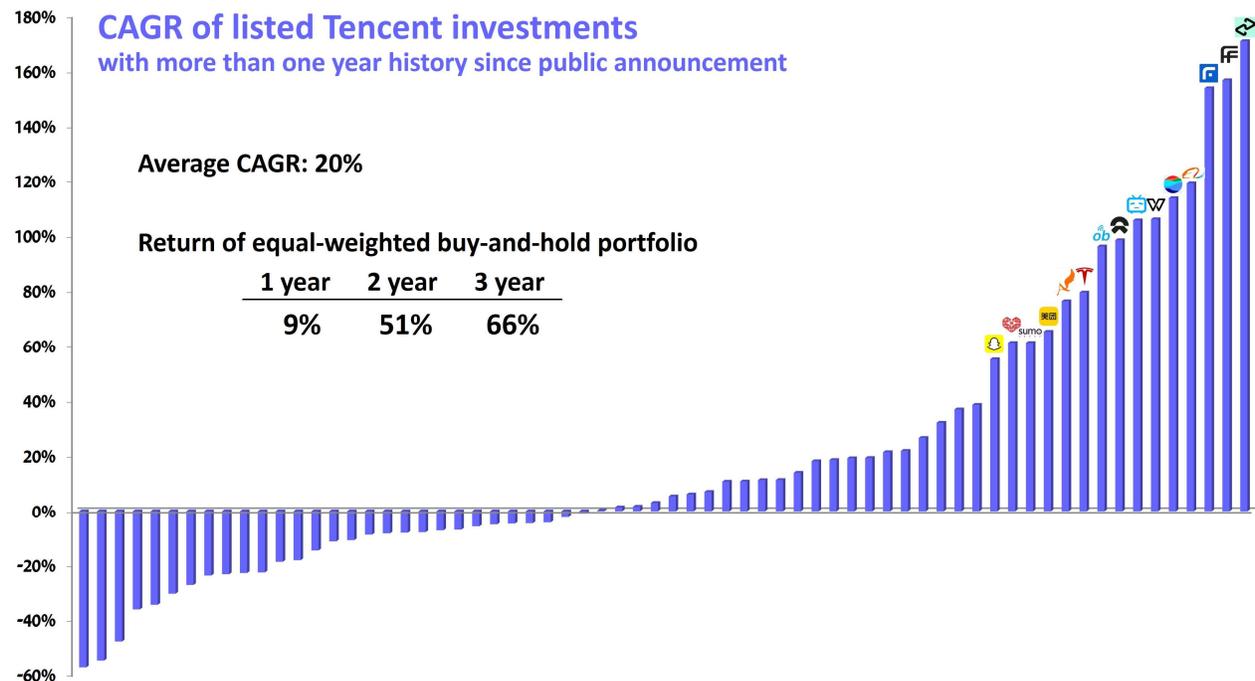


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Tencent made thousands of investments into other companies over the last two decades. Just in the first half of 2021, Tencent closed more than 50 deals on gaming investments alone<sup>20</sup>. While Alibaba occasionally exits holdings, as it did with Meituan or Didi, Tencent hardly ever sells or divests investments and, like Berkshire Hathaway, primarily keeps adding more...and more...and more...

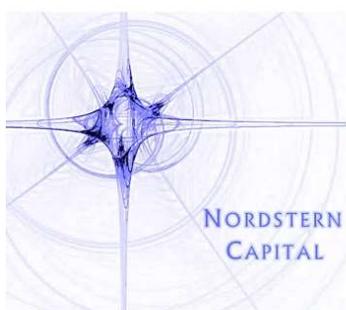


Tencent's portfolio of public company holdings end of June 2021 swelled to \$238bn<sup>21</sup>, which is about 35% of Tencent's total market cap. Reviewing Warren Buffett's investment success over his lifetime and comparing it to Tencent's growth in shareholdings of public companies gives some idea of where Tencent could go over time...



<sup>20</sup> <https://gamerant.com/tencent-yager-majority-stake>

<sup>21</sup> Value includes subsidiaries. Tencent reports fair value of shareholdings in listed investee companies excluding subsidiaries.



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The investment superpower of Tencent is to make early-stage private investments. However, if one had invested whenever Tencent either IPO-ed a portfolio company or announced an investment into a public company, the compound annual return rate would be around 20%. The results are driven by the 15 best performers, which more than make up for the plenty of declining public companies Tencent also holds.

## Thoughts on China

When the government blocked Didi's ride hailing apps this month it took Meituan only a few days to push into ride hailing themselves. China is hypercompetitive. Even though Chinese life is so dominated by WeChat and AliPay today, an armada of tech companies are waiting in the wings to replace the current monopolistic ecosystems tomorrow.

What really cements China Big Tech's durable growth for many years going forward is Alibaba's operating prowess and Tencent's investing acumen. That is exactly what is required to help the Chinese leadership to pursue their dreams of greater influence in the world.

Nordstern Capital's Chinese based investments are currently out of favor. However, our partnership is a firm believer in China's future and as such we are happy owners of outstanding Chinese companies. For one, if these companies can generate so much cash to keep piling up investment portfolios like no other, then they must be doing at least something right.

With all the best wishes,

*Johannes Arnold*

Nordstern Capital L.P.

By: Nordstern Capital Investors, LLC  
General Partner

Dr. Johannes Arnold, Managing Member

**This report is based on the views and opinions of Dr. Johannes Arnold, which are subject to change at any time without notice.**

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