

# Tao Value Q2 2020 Letter

July 23, 2020

For the quarter ended June 30<sup>th</sup>, 2020, Tao Value recorded a return of +36.45%, compared to +18.81% of MSCI All Country World Index (ACWI). This brings our YTD return to +18.76%, compared to -6.2% of MSCI ACWI. The past quarter marks the lowest net long exposure, yet the strongest performance in the history of our partnership.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year /YTD	MSCI ACWI
<b>2017</b>	+1.94%	+2.34%	+0.33%	+2.80%	+4.14%	+0.07%	+2.65%	+1.76%	+1.31%	+4.69%	+1.34%	+1.60%	<b>+27.91%</b>	<b>+23.97%</b>
<b>2018</b>	+2.07%	-3.85%	-3.74%	-0.80%	+4.81%	+2.99%	+2.20%	+4.16%	-0.87%	-7.26%	+3.79%	-5.53%	<b>-2.93%</b>	<b>-9.42%</b>
<b>2019</b>	+7.68%	+2.62%	+3.19%	+1.46%	-6.54%	+3.28%	+2.40%	-1.53%	+0.43%	+0.52%	+2.42%	+1.25%	<b>+17.88%</b>	<b>+26.58%</b>
<b>2020</b>	+1.88%	-2.56%	-12.32%	+10.50%	+10.68%	+11.56%							<b>+18.76%</b>	<b>-6.20%</b>
<b>Since Inception (*January 1st, 2017)</b>													<b>+73.82%</b>	<b>+33.33%</b>
<b>Annualized</b>													<b>+17.11%</b>	<b>+8.57%</b>

## Contributors & Detractors

Contributors		Detractors	
Position	Performance (bps)	Position	Performance (bps)
Long SE	809	Short ACWI	-197
Long PDD	696		
Long YY	310		

\* Exited position

Our top contributors this quarters are **Sea Ltd (ticker: SE)**, **Pinduoduo (ticker: PDD)** and **JOYY (ticker: YY)**, adding 809 bps, 696 bps and 310 bps respectively. The largest detractor this quarter is **Short ACWI ETF (ticker: ACWI)** with -197 bps.

As of the end of this quarter, our top 3 positions are **Cash**, **Sea Ltd (ticker: SE)** and **Alphabet (ticker: GOOG)**. Collectively, they are 40% of the portfolio.

All top 3 contributors are beneficiaries of the accelerated societal digitalization induced by the COVID-19 pandemic. Mr. Market has been very generous in pricing such acceleration.

**Sea Ltd (ticker: SE)** released another strong results for 20 Q1 in May. Gaming business revenue grew by 31%, with healthy active user growth of 48%. E-Commerce business booked 74% y-o-y increase in GMV, yet on a slightly low take rate of 5.1% (compared to 6.3% of 19 Q4) possibly due to relief measures to merchant amid the pandemic. Helped by the acceleration of digital transformation benefiting SE's all 3 businesses and the overwhelming liquidity injected by government, SE advanced 145% over the quarter.

**Pinduoduo (ticker: PDD)** is one of our highly convicted ideas since Q3 18. The original thesis can be viewed in our Q3 18 letter<sup>1</sup>. It gained 139% over the past quarter. Like SE's performance, I think such performance is driven more by the uneven asset price inflation from both fiscal and monetary stimulus, than business intrinsic value creation. On business side, PDD disclosed faster than expected GMW growth during Q1 2020, yet larger than expected loss due to relief measures for merchants. During the earnings call, management disclosed many details from which reaffirm strong rationality. For example, CEO Colin Huang mentioned that increasing ARPU is not part of management's KPI but believe that it would be a natural outcome if they increase users' engagement. They also disclosed a key metric for measuring the engagement – MAU/Annual Active Buyer, which increased from 65.4% Q4 19 to 77.6% during Q1 20. This shows PDD's management really sees through the essence of its business driver and has good measurement on what matters the most. Although I typically don't comment on developments in the new quarter, I would make an exception here to discuss about Huang's big announcement on July 1, 2020, to step down as CEO and to reduce his stake from 43.3% to 29.4% (all of which are transfers, not sales). The key risk is how much Huang still intends to involve in PDD. Huang seems to have grand goals, and PDD may be just a start. We will see how the succession plan folds out and act accordingly.

**JOYY (ticker: YY)** gained 66% in the past quarter. Main highlight is the fruition from the successful international expansion of entertaining live streaming model (Bigo). Bigo segment reported quarter revenue of 2.1b RMB, which is on par with the domestic YY Live segment, yet still on a 99% YoY growth trajectory. Management also commented that they could monetize effectively (sharing 45% revenue with hosts, lower than domestic practices) due to lack of competition. On short form video side (Likee), it seems like management conceded to the mighty TikTok and will focus on differentiated markets & segments.

The only meaningful detractor this quarter is the index hedge (Short **ACWI**) we put on, which dragged the portfolio by -197 bps.

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## **Portfolio Updates**

### **Avalara (ticker: AVLR)**

We have built a position in Avalara, a sales tax and compliance software company in early stages of a secular growth runway. The COVID-19 pandemic made it clear that the future of commerce will be a closely integrated on-line & off-line experience. I see the business tax & compliance as a lagging & under-addressed function within the value chain, for which Avalara is positioned well to capture.

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<sup>1</sup> [https://taovalue.files.wordpress.com/2018/10/taovalue\\_2018\\_q3\\_final.pdf](https://taovalue.files.wordpress.com/2018/10/taovalue_2018_q3_final.pdf)

**Tao:** Tax is complex and painful. For most of mid-sized businesses, manual spreadsheet-based sales tax calculation tool might work if they only subject to a few tax jurisdictions. Yet looking 5 years out, I believe all successful businesses regardless of size will be digitalized ones, which inherently means they will transact with customers across region and have tax implications for hundreds, if not thousands tax jurisdictions. While large enterprises may afford internal teams to handle taxes, mid-sized business will need the help from some software solution to streamline it. Avalara is a clear leader in addressing this problem, with a very mission driven culture.

**Meteorology:** It is the strongest factor among others. The strong tail wind for this niche market can be attributed to 1) eCommerce acceleration; 2) Accelerated cloud business solution adoption & 3) Legislation & enforcement bodies' catching up. By comparing AVL R determined sales tax to total US midmarket sales tax collected by government, I estimate AVL R only penetrated less than 5% of its core addressable market. With the core sales tax relationship built, cross selling new solutions around the compliance theme will also be a reasonable & unchallenging strategy to further expand its market.

**Topography:** I believe AVL R has built a narrow moat by closely integrated with over 700 business applications (e.g. ERPs, Marketplaces). Management also see the importance of “partnering with all applications that create invoices”, which will create superior streamlined user experience. This also explains why Sales & Marketing expenses has been high as AVL R had been aggressively establishing such partnerships and sharing referral fees.

The moat can be visually seen from the 110% average net revenue retention rate, which means existing customers a year ago, after adjusting for termination, pricing change & upsells, pays AVL R 10% more on aggregate today. The churn rate is consistently lower than 5%, implying customer life of 20+ years. Both metrics speak for the stickiness of the products.

**Commander:** CEO Scott McFarlane is a co-founder of the company in 2004 and has held the helm since 2007. Based on my research, McFarlane seems to be good at leading by mission.

**Valuation:** for the AVL R's public market existence, it has never been cheap by traditional metric, which it shouldn't to be fair. For example, on forward EV/Sales basis, it was priced between 11-17 times. I was able to build a desired position at implied forward EV/Sales of 12.

### China Index Holding (ticker: CIH)

It is a small micro-cap special situation position. I believe the stock is deeply undervalued due to a combination of setups. It was spun off a year ago from **Fang Holdings (ticker: SFUN)**, a failing Chinese real estate internet portal. CIH's core business is to collect, clean and sell real estate data & research to all RE participant in China, a good asset-light business. The business has high 40+% operating margin, and still growing at 20~%. Yet it was traded at some absurdly low valuations, like 4x PE or 3x EV/EBIT. One reason for such low valuation can be attributed to the poor governance under the Chairman Vincent Tianquan Mo and his valuation destruction history at SFUN. Another reason is possibly that Mo

decided to use direct listing (which was only successfully pulled off by a few very well-known companies, like Spotify & Slack), and without any financial advisor. As a result, CIH still have no institution equity research coverage yet. Through background research, I found Mo though known to be very parsimonious, is enterprising. Although risks abound in such a tightly controlled illiquid Chinese stock, I believe the price we paid is with margin of safety and worth investing at the right position size.

## Others

We trimmed **Meidong Auto (1268.HK)** on the day the CEO disclosed a sale of 4.5% of the shares at price of HK\$ 12.82. We trimmed **Credit Acceptance (CACC)** on the day the company announced it would delay filing Q1 reporting & annual proxy material, which at that point, appeared suspicious. We also trimmed **Pinduoduo (PDD) & Sea (SE)** to control their relative size in our portfolio.

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## **General and Market Commentary**

The past quarter was a quite active one in terms of trading. On one hand, the pandemic impacted businesses differently changing my perception about individual companies. It led to actions to reflect such changed perception. On the other hand, a few holdings' prices appreciated significantly. That changed the future risk/reward profile, for which I adjusted positions to account. The overall performance of our portfolio this quarter may appear satisfactory, yet there are a few places I could have done better. I'd like to share with you a streamlined workflow helping me uncover such insights.

A key question I ask myself is that whether each of my action add value to our long-term success. For all trades I did on a trailing one-year basis, I track and study their opportunity costs up to current day, or in other words, to see how much value my action added or destroyed up to current quarter end. Below table is a high-level summary, yet some explanation is warranted first:

- Open Close Indicator: it indicates whether such action is open (O) a position (i.e. increase exposure), or close (C) a position (i.e. decrease exposure). Thus, closing or trimming existing position would be categorized as C, and starting a new position or adding to existing ones would be O;
- Total Activity (%): it's calculated as sum of \$ value of buys & sells over NAV at current quarter end;
- Net Activity (%): it's calculated as \$ value of buys – that of sells, over NAV at current quarter end;
- Standalone Impact (%): It's the % of return on activity's notional alone, calculated as \$ P/L over \$ value of total activities
- Impact Contribution (%): It's the % of contribution of such activity to the portfolio, calculated as \$ P/L over NAV at current quarter end.

		Total Activity (%)	Net Activity (%)	Standalone Impact (%)	Impact Contribution (%)
qtr	openCloseIndicator				
2019Q3	C	6.2	-6.2	-10.9	-0.7
	O	7.5	7.5	215.8	16.3
2019Q4	C	4.9	-4.9	35.5	1.7
	O	0.8	0.8	173.4	1.4
2020Q1	C	5.1	-5.1	-25.2	-1.3
	O	17.0	2.4	25.7	4.4
2020Q2	C	21.5	-12.8	-35.4	-7.6
	O	13.6	5.3	-0.5	-0.1

I want to note upfront that near-dated value impact is not completely reflective, because many times I don't believe Market Price is reflective of intrinsic value in short term. Thus, in general, I focus more on older data. Take 2019 Q3 for example, we saw O(pening) trades (which increase exposure) created significant value for us. On standalone basis, these positions more than doubled (returned 215.8%), contributing 16.5% increase of our portfolio value. As our 19 Q3 letter<sup>2</sup> shared, these are new positions of **Meidong Auto (1268.HK) & Sea Ltd. (SE)**, both of which more than doubled since our initial purchase. In other words, had we not purchased them, our portfolio NAV at end of this quarter would be 16.3% lower!

To drill down further and understand individual trade level impact, I also have below interactive bubble plot showing me time on X-axis, Value Impact (bps) on Y-axis, trade notional value as the size of the bubble, and Open/Close Indicator as color. This chart gives me a multidimensional view of how I did with the most intricate trade level granularity. One pattern confirmed from this chart is that I generally do worse for closing/reducing positions than opening/adding positions, as you can see more orange bubbles toward negative value impact territory. Admittedly, selling by nature is harder than buying.



<sup>2</sup> [https://taovalue.files.wordpress.com/2019/10/taovalue\\_2019\\_q3\\_final.pdf](https://taovalue.files.wordpress.com/2019/10/taovalue_2019_q3_final.pdf)

Although maybe too soon to judge, we also saw, from zoomed in 2020 Q2 chart below, our C(losing) trades in the past quarter destroyed quite a lot value, contributing -7.6%. i.e. Had we not trimmed these positions, our portfolio NAV would have been 7.6% more. Among others, the largest two are trimming of **Credit Acceptance (CACC)** and **Meidong Auto (1268.HK)**. As mentioned before, my decisions were based on new company specific information (delaying SEC filing for CACC & block insider sales for 1268.HK). Yet, both stocks appreciated significantly from when we did the trimming. Retrospectively, I may have overacted to news.



## Final Note

The journey of life-long investing is as much of learning inward about yourself as studying outward the world. Without the former, one is merely a stock picker, not a true investor. Uncovering my own strength, weakness & biases helps me to position myself better in different scenario, so I can know to be assertive and aggressive in certain situations, while humble and cautious in others. With that been said, I look forward to report to you next quarter.