QUARTERLY COMMENTARY

31 March 2022

Manager Update: April 2022

John Qiu, Founder

Lenin's quote: 'There are decades when nothing happens; and there are weeks when decades happen' is particularly apt when applied to the events since mid-February. Starting with the Russian invasion of Ukraine to the nationwide Covid lockdowns in China and Hong Kong, these black swan events triggered cascading volatility eruptions across almost all asset markets including a 10-sigma move in the nickel market in the first week of March. The theoretical probability of such an event occurring is once every half a septillion year (1 followed by 24 zeros)! But the fact that it happened shows the 'impossible' will regularly happen, somewhere, somehow, sometime and that reality needs no permission or proof for its own existence.

Equity markets also fell precipitously with offshore Chinese tech stocks among the hardest hit areas. At the lows on March 15, the Hang Seng Tech Index (HSTECH) and the Nasdaq Golden Dragon China Index (HXC) were down -40-45% month on month (pre-Russia/Ukraine) and -70-75% from their peak in February 2021. The magnitude of the collapse is comparable to the biggest stock market crashes in history including the Asian Financial Crisis, the Dot-Com bust and the Global Financial Crisis. Although both bounced back spectacularly in the second half of March (+30% and +48% respectively), these indices are still down -15-20% YTD and -60-65% from February 2021.

Entering the tumultuous mid-February period, our fund positioning was not ideal. The portfolio gearing was ~1.3x and over 50% of the portfolio was invested in Hong Kong and US listed Chinese non-energy stocks (mostly tech and consumer companies). Despite this, the fund ended our first quarter up 38% YTD. We ascribe our outperformance to these factors:

1. We had 1/3 of our portfolio invested in cheap oil & gas related companies and another ~10% in tobacco stocks

2. We aggressively recycled our capital into the highest risk/reward companies as markets fell. We trimmed some of our energy exposure and monetised many long-time holdings including all of our tobacco positions. Although the companies we sold were undervalued, we believed we were swapping 20-30% upside for >100% upside opportunities

3. We allowed our gearing to rise to the limit of 1.5x and took in further capital to take advantage of the abundance in opportunities

In hindsight it may seem obvious that valuations had become too extreme but the proverbial 'buy when there is blood on the streets' is never easy nor obvious at the time. It was the combination of investment philosophy, operational model and the emotional memory of having experienced many past market crashes that gave us the fortitude to continue buying as others were selling. This is exactly the type of market where the Orlog model does best – when the industry weathermen are calling risk assets 'uninvestable' and industry captains are stampeding for the exits driven by falling passive stock indices and fears over losing clients, reputations and even their own jobs.

Unlike our institutional peers, at Orlog our own capital is always on the frontlines and the chips on the table include most of our life savings. We stay hungry and never comfortable because we must, and even as we grow, we remain revolutionaries, never to be held hostage to the safe, civillised mediocrity that defines this industry.

Post the strong price rally since mid-March, the risk/reward of individual stocks has decreased and accordingly our portfolio gearing has reduced considerably. Even so, the current discount to our low-end estimate of fair value for portfolio companies is well over 40%. These stocks remain primarily the Hong Kong and offshore listed Chinese companies. More extreme risk/reward payoffs can be found in Russia/Ukraine related stocks which we started buying in late February/early March at good prices. These are all non-sanctioned, well-run private companies. While we are against this war, we do not agree with the isolation of Russian civilians and private businesses.

Looking forwards we don't know how geopolitical events and macroeconomics will play out, much less future market reactions to real and perceived storms. Our biggest concern is the rising cost of capital and reduction in liquidity which will have a major influence on Western economies and financial assets. China in comparison, has room to maneuver both in monetary and fiscal policies.

Of course all this is well known by the markets and we do not seek to compete based on our macro views. Our focus is always on individual companies and the only impact to our decision making today is a higher internal requirement on investment return for portfolio candidates. We expect asset prices and performance to be volatile but this is something we welcome. Ultimately we live by the belief that the best guarantee of long term performance is how cheaply you buy assets and the risk of absolute loss. On this basis we are optimistic on future investment results.

For our stock analysis this quarter, we've chosen Dada Nexus, one of the companies which we aggressively bought during the March stock market collapse.

About DADA

DADA is a subsidiary of JD.com (52% ownership) and operates two businesses:

- JDDJ: an Online-to-Offline (O2O) retail marketplace platform
- DADA Now: a crowd-sourced last-mile delivery platform for goods (non-food delivery) and documents

JDDJ

JDDJ is the biggest non-restaurant O2O retail platform in China with 62.3m active users and RMB43.1bn in gross merchandise value (GMV) sales in 2021. Supermarket goods make up majority of the sales on JDDJ with the rest coming from consumer electronics, home appliances, apparel, pharmacies, cosmetics. It does not do any restaurant related business. Within the supermarket category, JDDJ leads in market share with 27% of GMV in 2021 (well ahead of no2 and no3 at 16% and 9%).

The value proposition of JDDJ is two-fold:

1. To Merchants: it provides a 'plug & play' system and traffic to expand sales online. This hybrid model is essential for offline retailers to improve cost efficiency and survive against pure online e-commerce
2. To Users: delivery speed and freshness is better than pure e-commerce players. Orders are typically fulfilled in <1hr (from purchase to door) and offline supermarkets hold the largest fresh food inventories

While the O2O food delivery business is well known globally, O2O retailing in other goods is just starting and China is leading the adoption trend. Even so, in 2021 70% of retail sales in China was generated by offline stores but of this <2% was from O2O. This is growing rapidly with O2O retailing expected to reach 8% penetration by 2025 or >50% 4 year CAGR. Supermarkets are the leading adopters but their O2O sales % was still <5% in 2021 and expected to reach 16% by 2025 (>50% 4 year CAGR).

JDDJ runs its own independent apps, websites and is also integrated in the JD.com ecosystem. Recently in October 2021, JD.com and DADA started a new shopping service: Xiaoshigou (Shop Now), which is the exclusive provider of 'on-demand' retailing. So all purchases marked as <1hr delivery (O2O fulfilled products) are powered by JDDJ.

JDDJ makes money by (% GMV):

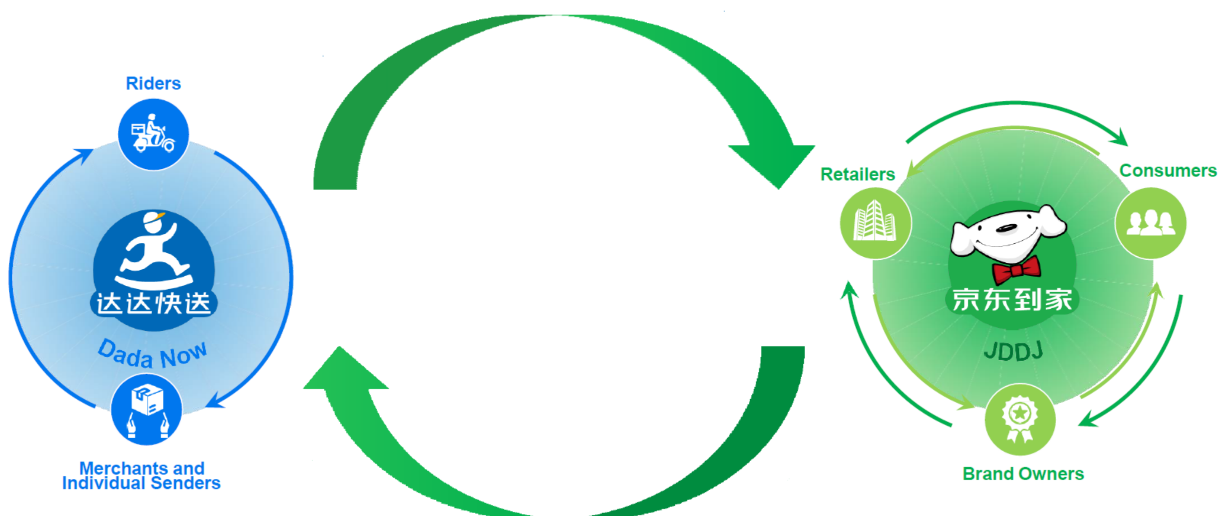
- Commission rate: 2-3% for supermarkets, 1% consumer electronics, 5-10% other categories
- Online marketing: ~3% today and rising. These ads are mostly from Brands for new product launches and promotional campaigns. They link to nearby physical stores and deliver transparent direct sales outcomes

The combined Commission + Marketing Rev % GMV was 5.5% in 2021 and trending upwards due mostly to Online Marketing growth. Brands are attracted by the transparency and high ROI as well as the dual benefit of supporting traditional offline sales channels.

DADA Now

Dada Now is the largest crowd-sourced last mile delivery service which serves JDDJ, JD Logistics (and therefore majority of JD.com) and retail chains and SMEs. The service is valuable because utilisation of delivery riders is uneven across time e.g. food delivery orders peak during meal periods. Sharing rider resources improves rider pay, lowers costs for platforms and increases rider availability for fulfilment.

Although crowd-sourced delivery services is not unique, having the high (and predictable) volume traffic from JD Logistics and DADA supports higher efficiencies than platforms elsewhere in the world. This drives a virtuous cycle of fulfillment capability and rider loyalty.



Why we like DADA

Similar to JD.com, DADA is a business built on leveraging rising economies of scale. As its User traffic and spending grows, it becomes an increasingly important sales channel for offline retailers which encourages greater digitalisation and integration with DADA. This drives cost efficiencies in picking and delivery systems which translates to better product choices, customer service and lower unit costs. Profitability is a natural result of hyper-growth on the top line and margin expansion due to monetisation rate and operational cost savings. We believe the certainty of this cycle continuing is high due to these factors:

1. JD.com relationship

- JDDJ's 62.3m user count is merely 11% of JD.com's 570m userbase. This penetration will increase rapidly and at low cost to JDDJ. The situation reminds us of JD.com in its early years tapping into Tencent's Wechat platform users
- Dada Now's growth is tied to the high order volume growth rate of JDDJ, JD.com and external O2O
- Improving economics from shared logistics resources and merchant relationships

2. Walmart owns 10.1% of DADA and is the second largest source of orders to DADA

3. China's fragmented offline retailing landscape: lower ability for physical retailers to invest and develop independent online businesses. Even the large retailers Sun Art, Suning, Gome have largely failed in their efforts

4. Continuing rise in monetisation of JDDJ

- Online marketing: we believe this will grow faster than GMV due to JDDJ's expansion in brand SKUs and brand ad/marketing budget allocations. In 2021 JDDJ's Ad Rev/Active Consumer was RMB22 and we think at the very least this can double over the next few years (for comparison, Alibaba's Ad Rev/Active Consumer was >RMB250)
- Commissions: major supermarket and home appliance stores have mid-teens to low 20% GPM. The additional operating costs to the retailer of servicing JDDJ generated sales is minimal which suggests commission rates have room to increase from the current low single digits. Also JDDJ is penetrating smaller retailers who pay higher rates

Valuation

DADA share price closed at US$8.65 on April 11, 2022 which equates to RMB12.8bn MCap and RMB8.9bn EV.

We estimate the 3yr CAGR (to 2024) of JDDJ GMV at ~50% which is mostly underpinned by JDDJ User growth to 170m (~30% penetration of JD.com users by 2024). This in turn drives our estimate of DADA Group revenue CAGR of 45%. This growth can be self-financed given DADA's ~RMB5bn net cash position (including RMB3.4bn cash from JD.com's February 2022 shares purchase) and expectations for profitability by 2023.

DADA is currently loss making: -RMB2.5bn in 2021 (-40% OPM and -36% NPM). However the business is on the cusp of profitability with management expecting the DADA Now business to breakeven by year-end 2022 and JDDJ by 1H2023. Company forecast for 2023E GAAP NPAT is ~RMB500m (3% NPM) which means DADA is trading on 26x 2023E PE (and 13x non-GAAP PE). This is cheap given the growth rate even if one assumes margins stop improving.

However we believe this is far from DADA's longer term profitability potential. We estimate:

- JDDJ can achieve at least mid-teens OPM: JDDJ's business profitability should be comparable to Alibaba's China e-commerce which has OPM of >30% (pre-2020 figures before 'New Retail' became material and consolidation of Sun Art). JDDJ profitability will be lower given 1% GMV profit sharing with JD (only Shop Now sales), lower marketing revenues and assuming delivery (1/3 of Rev) is breakeven only
- DADA Now's sustainable OPM of high single digits. Accounting for this business is now net of delivery rider costs which is similar to ZTO (mid-teens OPM) but the fixed rate deliveries for JD Logistics likely drags down overall profitability

Using the above, we estimate DADA's margin potential at low to mid-teens OPM and ~10% NPM. On this basis DADA is trading at just 11x 2022E and 7x 2023E PE our estimate of DADA's sustainable profitability structure.

We think fair value for DADA is in the US$20s to 30s price range.

What could go wrong

Competition is likely the biggest risk. In the past the Chinese technology sector has been notorious for the fierce competition and massive cash burn to acquire Users and growth in new industries. Only after growth rates declined and/or majority of competitors were wiped out did rationale competition begin to focus on making money. Fortunately the competitive barriers to ‘on-demand’ retailing is high and the O2O industry has already undergone significant consolidation. Smaller players and startups are unlikely to be threats with competition to DADA mostly from Alibaba and Meituan.

We are comfortable DADA can maintain its market share lead and that monetization will not reverse. The reasons are:

1. Regulation: regulators have made it clear they do not want to see anti-competitive practices and we think the risk of a subsidies war is low. We already see multiple internet sectors pulling back on incentives and focusing on service quality. This type of healthy competition helps adoption

2. Logistics: we believe JD Logistics is superior to Meituan’s fulfilment system. Alibaba’s New Retail fulfillment network is good but the priority seems to be on integrating and servicing Alibaba’s investee companies

3. Platform traffic: we believe Alibaba and JD.com ecosystems are more suited to non-food O2O traffic than Meituan

4. Merchant support: Alibaba’s New Retail strategy has seen it make significant investments in offline retailers and its home-grown Hema supermarket business. This makes it less of a neutral platform vs JDDJ and Meituan at least in the supermarket space

Competition changes are rapid in China’s retail and online space and it’s possible our analysis becomes redundant quickly. Even if that was true, we are confident the fast growth in O2O adoption will continue and generate good returns for all the major players.

Lessor risks include contract terms with JD.com on ecosystem access and JD Logistics delivery prices. The current terms seem reasonable and we believe JD.com is similar to Tencent in the fair treatment and value they put on investee companies.

Final Comments

Our core investment philosophy is based on looking for misunderstood and mispriced companies. DADA is one such company and a symptom of the times. The general understanding of technology businesses has never been great with investors usually falling into either the ‘growth at any cost’ club or the ‘value based by the book’ society. The former are being burned by rising interest rates while the later still lack the imagination to look beyond textbook ratios. Compounding this are over-hyped China fears which is now giving investors the opportunity to buy an early stage Alibaba on the brink of profitability for just US$2bn, a mere fraction of its true value.

Portfolio Overview

ORLOG CAPITAL

Top Five Major Holdings (in alphabetical order)	
Alibaba	E-Commerce
CNOOC	Oil & Gas Exploration & Production
CVR Energy	Refinery
DADA Nexus	E-Commerce
JD.com	E-Commerce

Performance

Disclosure of performance figures will start next quarter after the Fund has accumulated 6 months of performance data

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