QUARTERLY COMMENTARY

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Manager Update: July 2023

John Qiu, Founder

Evolutionary theory describes the process of natural selection as: countless traits, both inherited and arising from mutations, compete and face the challenges of their environment. The more 'successful' traits have a higher probability of surviving and being inherited by the next generation. This continuous cycle of constant adaptation to the environment ensures life has the best chance of enduring. Ever since I came across this theory in university, it has deeply influenced my thinking, which includes views on business and economic interactions.

Like organisms, businesses compete and evolve to best serve demand and capture resources. Their behaviour within the ecosystem of markets, is similar to relationships found in nature and can be understood through the lens of evolutionary theory, population ecology, etc. We incorporate aspects of this in our research including:

- Like natural systems, we believe competition dynamics are the primary determinant of cycles and the limits of individual profit capture. We tend to focus on supply side analysis over demand side since this is where most factors of competition lie

- We closely study key competitive factors for an industry across time, and the expression of the related traits in companies. We try to quantitatively measure and compare traits where possible e.g. JD's cost advantage

- We see the market as the only unbiased judge. Therefore, we do not base our investment theses on predicting or rationalising product outcomes e.g. a product shift to cloud will drive market share gains since cloud is more convenient, a new product will be successful due its high quality and low price, etc. For the same reason, we generally avoid turnaround stories in consumer businesses

- We accept boom/bust cycles as inevitable, but also that rebalancing occurs with time. We are prepared to wait and act, counter to the cycle. We use history where possible, as a guide to understand these cycles

One can see some of these dynamics in our past stock writeups, which, in conjunction with their low pricing, made these companies attractive investment candidates:

- JD.com, Dada Nexus, Kion (key competitive traits, rational competition)

- Macau casinos, Spirit Aerosystems (low point in cycle, limited and rational competition)

This framework also bears some influence on our views regarding:

- **China's economy**: without a doubt, there is a lot of problems with China's economy today. However, we feel a neglected area of discussion is China's huge wealth differential and interaction with factors of competition. Domestic and global markets are mostly integrated allowing direct interaction between competitive factors yet China's average GDP per capita (~US$12,800) today is still 2-3x lower for poor vs rich regions; and 3-5x lower vs developed nations. We believe 'wealth osmosis', caused by the movement of these competitive factors (labour, market size, supply chain ecosystems, infrastructure networks, etc), remains a long-term fundamental driver of economic growth. This is seen domestically by on-going urbanisation, expansion of national companies into lower-tier markets. Internationally, this is seen by the growing number of Chinese multinationals

- **China's geopolitical risks**: we believe the economy drives politics longer term – people prioritise individual prosperity. Isolation of the world's second largest economy and largest trade nation is pushing directly against fundamental self-interests. China's geopolitical risks decline with economic growth and integration

- **Money printing/MMT policies**: nature has no examples of free lunches and evolution depends on improvement via competition for limited resources. It seems naïve to believe one society can adopt a long-term unlimited resource policy at the expense of other societies or that a society will thrive as a collective of lotus eaters

Perhaps given the blueprint of life was imprinted in all humans, it is also reflected in the systems we build and organise ourselves around. If one looks closely, the story of human history follows evolutionary pathways. The purpose is always expansion and domination of resources. The process is always based on competitive friction selecting for the fittest traits for that purpose (the book "Guns, germs and steel" by Jared Diamond is an interesting review of history based on these ideas). From that perspective, the current conflict between the U.S. and China was destined to occur. But while competition is unavoidable, it needn't always be destructive. As long as there are mutual growing shared interests, competition can become the type that enriches, rather than impoverishes all of humankind.

Our Fund performance was -17.6% QTD and -22.1% YTD (which includes the high single digit negative impact from our side-pocket action taken in first quarter 2023). This was disappointing but not surprising given our Fund's investment approach – we aim to accumulate absolute value, especially from bear markets.

The bulk of our portfolio remains invested in cheap offshore Chinese equities. We think these stocks represent bargain valuations: low multiples on depressed earnings, rock-bottom market sentiment, free options on government stimulus measures and liquidity expansion. The competition environment remains rational and the spread between domestic Chinese interest rates and equity yield is very attractive.

We feel the current portfolio is like a coiled spring, with significant upside should things just marginally improve. Also, there are a number of portfolio company milestone events over the next year which we believe could catalyse market repricing. We are optimistic about performance.

Our plan is to open the Fund to external investors in early 2024. We've started a prospective investor interest list on our website:

https://www.orlogcapital.com/invest

If the current market excites you, then perhaps we are a mutual fit.

For this quarter's stock discussion, we've chosen China Isotope & Radiation Corp.

About China Isotope & Radiation Corp (CIRC)

CIRC is a subsidiary (74% owned) of China National Nuclear Corporation (CNNC), the SOE responsible for all civilian and military nuclear programs in China. CIRC supplies a variety of nuclear isotopes used in diagnostic & therapeutic radiopharmaceuticals, industrial applications, irradiation services and clinical lab services. It also sells radiation therapy equipment.

Nuclear isotopes is a tightly controlled industry. Although there are no laws against private enterprise participation, CIRC enjoys a virtual monopoly due to the restrictive access to technology and raw materials, licensing and high capex requirements. CIRC is the only nuclear medicine entity listed under CNNC.

Pharmaceuticals

CIRC earns 60-80% of its revenues from its pharmaceuticals business. It produces and sells radioisotopes for imaging diagnostics (PET/CT, MRI), UBT kits, diagnostic reagents and kits.

This is a fast-growing area given the low penetration of China's nuclear medicine facilities (in 2019 only 10% or 1,000 Tier 1-3 hospitals had facilities) and scarce national healthcare reimbursement. The government has set the goal of full Tier 3 hospital coverage by 2025 (~3,000 hospitals) and every county to have nuclear medicine facilities by 2035. Also, only a few rich regions have nuclear medicine services on the national reimbursement list (e.g. Zhejiang: PET/CT) which we expect to change as these services become more widely available.

Radioactive source materials

The sale of radioactive source products used in a variety of medical and industrial applications accounts for ~10% revenues.

Irradiation

CIRC provides irradiation services to medical devices, food, medicine and cosmetic manufacturers. This division accounts for low single digits % of revenues.

Radiation therapy equipment/Other Businesses

CIRC supplies high end radiotherapy equipment for diagnosis and treatment of cancer. CIRC is also involved in various trade of radioactive source materials, instruments, medical devices and products. These businesses account for ~25% of revenues.

Why we like the Company

We started investigating CIRC in early 2022 after seeing how China's lockdowns and targeting of resources towards fighting Covid had negatively affected secondary and tertiary healthcare services.

Our understanding of key points are:

1. Competition is limited and rational. For the diagnostic & therapeutic market, the top 3 players hold >80% market share (CIRC >50%). Also, the no 3 player: Shanghai GMS is a 49% owned JV with the no 2 player: Yantai Dongcheng and even share mutual supply/distribution agreements

2. New competition risk is low due to high barriers on production, distribution and licensing e.g. many isotopes have short half-lives and irregular demand which makes near-by facilities and specialised logistics essential

3. Diagnostic & therapeutic sales is likely to recover quickly post lifting of covid restrictions (2022 was 80% of 2019 sales). Sustainable growth could >20% pa in a normal operating environment driven by nuclear medical facilities roll-out and oncology services

4. Risks on pricing from NDRL centralised procurement and other policies is low due to: a) irregular demand and short-half life - can't be volume procured, b) limited suppliers, c) low NDRL coverage, d) a tiny (and unimportant) portion of annual healthcare costs

5. Lots of free options including: gateway entity for radiotherapy devices & istope technology into China; benefits from having CNNC as its parent (R&D, human resources, government access); plans to dual list on SH stock exchange could benefit coverage and valuation

We believe the operational and financial risks for CIRC are low. And despite a difficult three-year period, CIRC still managed to grow with FY22 vs FY19 revenues 54% higher and NPAT 20% higher. Margins have declined but we expect this to recover as their image diagnostic & therapeutic business recovers (higher margin business, increased production utilisation).

Valuation

At the current mid-teens HK$ share price, CIRC is valued at ~RMB3.7bn MCap and ~RMB3.7bn EV (it has a net cash position of RMB2.1bn which is offset by similar size minority interests).

This looks very cheap considering it trades at mid/high single digit PE multiple on FY23E earnings where we expect earnings to grow in the high teens to mid-20s sustainably for many years. Also, with a dividend payout ratio ~30%, it offers a 3-5% dividend yield.

Why is it Cheap?

Despite being a dominant monopoly operator in a fast growth niche industry, CIRC is only covered by one sell-side firm: Guoyuan Securities and their last update was almost a year ago. The company has a very limited IR department and the shares are very thinly traded.

The attractive valuation, good growth and dividend yield offers CIRC a position within our portfolio, despite its illiquidity and the lack of near-term repricing catalysts. If the A-share listing goes ahead and/or market interest in healthcare/oncology related companies resumes, CIRC could re-rate. Pre-pandemic, the market priced CIRC and similar medical companies on 20s-30s time their earnings multiple. Given the quality of its business and growth, it wouldn't be crazy to see CIRC at these valuations again.

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[2]	
Annualised Net Returns in US$[1]	
Since Inception (Jan 3, 2022)	2.6%
1 Year	-20.6%
Non Annualised Net Returns in US$[1]	
Year to date	-22.1%
3 months	-17.6%
6 months	-22.1%

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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