ORLOG CAPITAL

QUARTERLY COMMENTARY

31 December 2024

Commentary

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Manager Update: January 2025

John Qiu, Founder

The last five years have been among the most intense years in my 17-year career in buy-side equities. Much of it was self-chosen as I pursued the most extreme areas of market mispricing. As I look back at the investments made in oil & gas producers, refineries, industrials, casinos and various Chinese equities, these have been among the best and purest expressions of my contrarian, fundamental-value based investing philosophy. Results were strong in the first three years but have disappointed over the last two years. A lot of this has to do with the current meta of the investing game but crucial mistakes were also made, particularly on position sizing and trading. I've been reflecting on how to improve this while still holding fast to our areas of competence. The three main areas where changes will be made are: 1) top 5 position management, 2) buying levels, 3) portfolio gearing. Improving these areas will help optimise results from our stock picks and the risk/reward of the fund.

Almost a decade ago, I asked Midea management why Chinese companies were increasingly overtaking global rivals in home appliances and white goods. Their explanation was consumer electronics is driven by small innovations and improvements. China's domestic market is the largest and fastest growing in the world which meant more resources to reinvest and also greater pressure to compete. In contrast, many famous Western brands' home markets had long passed their boom years and were now stagnant and small. Therefore, these companies were happy maintaining their stable, profitable market share and spent less on product development. When they expanded overseas, localisation in places like China was often slow and poor as key functions and executive decisions were still being made at headquarters. Their product cycles were slower, pricing was less dynamic, and channel penetration was low. Chinese majors were able to win more of the mainstream Chinese market through better price, features, variety and larger scale which established their base for premiumnisation and overseas expansion. That assessment proved accurate: in 2024 the top 3 global household appliance manufacturers by sales were all Chinese companies: Midea ($53bn), Haier ($37bn), Gree ($28bn); well ahead of other global peers: Whirlpool ($19bn) and SEB ($17bn).

This is true for many industries. China's 1.4bn population living in high density urban population centres makes it a top global market for many products. At the same time, the environment is hypercompetitive starting at the individual level all the way up to institutions. The massive market alongside crucible like competition conditions drives the rapid evolution of private businesses at a pace rarely seen elsewhere in the world. Innovative products and value for money are key at every price point. Global leaders have emerged from the ranks of these domestic champions in areas such as: electronics, mobile phones, drones, medical devices, industrial machinery, auto components, green technologies, new energy vehicles. Many multinational companies have also been winners from adapting to these conditions. Just look at Tesla: China is its second largest market (657,000 cars or 37% of global sales in 2024) and the only major growing EV market (90% of 2024 global EV growth) accounting for 70% of global EV sales. Tesla's Shanghai factory is its most efficient globally and produced >50% of its cars (>950,000 cars pa with ~1/3 exported). The market size, production efficiencies, and supplier ecosystems are not found anywhere else. This is why German auto majors and Tesla opposed the 2024 EU tariffs on China's EV imports – there are no commercial alternatives.

The same factors are at play at an even greater scale in China's services sector. A decade ago, China only had ~45% internet penetration (developed countries reached this level in 2004) and banking was done mostly over the counter and paper filed. Today, majority of Chinese are mobile internet connected and use cashless digital payments. Entertainment media is now mostly digital, with engagement increasingly a data driven science rather than an art form. Retail speed-ran through supermarkets, malls and specialty retailer formats to e-commerce, with the penetration jumping from ~11% in 2014 to ~30% today (US and EU penetration still only mid-teens). Today, delivery speeds for online orders are closing in on sub 30minutes in many urban areas while even yak herders and senior citizens are regular e-commerce users. The scale and speed at which supply chains and distribution layers have been restructured and built in pursuit of efficiencies is mind boggling. Business models, processes and industries which may have taken decades to establish in other countries, get adopted and reinvented and disrupted within just a few years in China.

In short, China's market environment is fertile breeding grounds for highly competitive private enterprises reiteratively solving for better products and services. While the world has already witnessed the rise of Chinese manufacturing and goods exports, it is only beginning to see the spread of its services. Over just the past five years, services such as TikTok, Temu, Shein, AliPay/WechatPay have become popular internationally. New services such as RedNote, JD/Alibaba services, Keeta, Luckin Coffee are starting their global expansion. In gaming, there has been a noticeable rise in gamer enthusiasm over the past year for Chinese studio creations with the release of Black Myth Wukong and Marvel Rivals. The common theme among all these Chinese services are: they're excellent at providing what the market wants at a far better price than what the market was willing to pay. They've done this by harnessing massive scale foundations and prioritising customer satisfaction over profit optimisation. This is proving to be hugely disruptive to existing cosy oligopolies within media, entertainment, retail and many other industries in a pattern that faintly resembles the Midea example.

China Inc is globally competitive and still expanding. Almost nobody disputes that and yet investors are still avoiding the opportunity to buy some of the best companies in China (and globally) at bargain valuations today. The pervasive market pessimism may seem justifiable from a top-down perspective, but from a bottom-up perspective, the market is throwing out the baby with the bathwater in pricing high quality companies, including industry leaders and monopolies, at high cashflow yields and/or below replacement cost. Many are still enjoying fast growth, notwithstanding the poor macro, from market share gains, rising cost efficiencies and international expansion. These are the fundamentals that eventually matter for future returns.

Meanwhile, the Chinese government continues to pull out all stops to reinflate equity asset values. In 2025, there will likely be record levels of liquidity injections, state and institutional stock purchases and capital returns from companies. This maintains significant upwards pressure on the market, raising both the probability and pace of price mean-reversion back towards fundamentals.

In this market where investors crowding into speculative assets are pushing them to new astronomical highs, I believe now, more than ever, in staying contrarian and buying out-of-favour value. These continue to be the Chinese equities. It helps that both fundamentals and game conditions are increasingly on our side.

Fund Update

The fund ended 2024 with a disappointing -13% net return for the year. Annualised performance since inception (Jan 2, 2022) was -5.7%. Accepting periods of underperformance comes with our contrarian strategy though this has been the longest period of negative performance in our career (and also among the most extreme in terms of market pricing).

The biggest negative contributor during the year was Dada which declined from $3.32 to $1.21 while our investments in CNOOC and Full Truck Alliance were the biggest positive contributors. During the quarter, we trimmed positions after the late September China equities rally and later reinvested the proceeds mostly into Macau casinos and China Education Group. We remain puzzled why Macau casinos are still priced at 2021/2022 levels (covid-era and pre-license renewal) despite the surging recovery in activity.

Dada revisited

Dada has been the single biggest disappointment for the fund since inception. We were far too optimistic about JD Now (the on-demand retail marketplace business) and because of that, the group's breakeven timeline. When the accounting scandal emerged in early 2024, we correctly concluded it would have an immaterial profitability impact but failed to anticipate the subsequent severe deterioration in JD Now's ad/marketing revenues. Frankly, the old management team may have exaggerated much of JD Now's business and it's likely (given JD's large purchases of Dada shares) that JD wasn't aware of this either until late 2023 when large parts of this business had transitioned over from the independent JDDJ app to the JD app.

However, we seem to be correct on one crucial thing: JD's commitment to Dada and to on-demand retail. The Appendix shows two screenshots of the JD app taken in mid-December 2024 in Guangzhou. Since late 2024, JD has been A/B testing new versions of their app. The app format has changed with the main shopping page now split into 首页 "Home" and 秒送 "Instant Delivery" zones (and also 新品 "New Products" in version 2). "Home" is JD's normal e-commerce and "Instant Delivery" is JD Now. This is a huge traffic and visibility upgrade for JD Now which has become a primary category. Previously it was mostly accessed via a subservice panel (alongside JD flash sales, JD live-broadcast, JD supermarket, JD finance, etc) on the main shopping page. This follows on the footsteps of other significant changes at Dada in 2024 including: a) hiring former Meituan VP: Guo Qing as the new chairman and former Meituan GM of Takeaway Development: Yang Wenjie as the new head of JD Now, b) unifying branding by consolidating JD Hourly Delivery and JD Daojia to just JD Now, c) expanding new offline merchants and verticals including large food and beverage chains.

So where do we stand on Dada today? Operationally, Dada Now (last-mile express delivery service) is growing strongly (FY24E ~40% rev growth) and reached positive GAAP operating profits, well ahead of our expectations. Margins are still expanding from the growth in scale and due to accounting (faster 3P vs 1P growth). We estimate FY25E GAAP operating margin in the range of mid-single digit to low-double digits. JD Now is still restructuring – shifting activity to the JD app and finding a bottom for the ad/marketing business. Because of this, revenue has been declining yoy for each of the last four quarters to 3Q24. However, the absolute revenue amount may have troughed in 2Q24 and qoq revenue improvements could continue alongside the growth in JD app activity (verbal indications by the company is that this is trending strongly). If all goes well, yoy revenue growth should resume by 2Q25. The company has done a good job of reducing operating expenses with our estimated quarterly GAAP operating losses for JD Now relatively flat qoq for the past four quarters to 3Q24. At the Group level, Dada's 9M24 total operating losses was similar to 9M23 due to positive Dada Now contributions offsetting JD Now losses. It's likely Group losses will reduce in coming periods. Group net cash was RMB2.8bn at the end of 3Q24.

The two primary ingredients for this thesis to work out are:

1. Traffic and purchase activity continues to scale up
2. Cash burn is < time required to breakeven

The main points in favour of these conditions being met are:

1. JD's operational support for JD Now: complete integration into JD's ecosystem is on track which supports continuing traffic and activity scaling. Currently JD Now % penetration of JD's >600m active users is only high-single to low double digits
2. Fast instant retail industry growth: instant retail (<1hr delivery) grew ~mid-20% in 2024 vs overall retail growth of low single digits. Pushing delivery speed and convenience is the next frontier for China retail

3. Dada Now profits likely to continue ramping: high baseload order volume from JD Logistics (cost-plus contract) supports scale cost efficiencies. This makes it a competitive alternative to Meituan, SF Express which is why 3rd party orders have grown so quickly. Profits and margins are likely to continue scaling up

4. Long cash runway: FY24E is probably peak cash burn at <-RMB600m. Even at this cash burn rate and without any borrowings, this is >4yrs runway. However, reaching positive cashflows is possible by FY26

5. Complete management overhaul: the old management team is gone. The new management team composed of senior ex Meituan and JD group executives have made promising progress turning around JD Now

The main risks are:

1. Dada operations are highly dependent on JD, leaving it vulnerable to JD app changes and JD Logistics contract

2. Fierce competition in Instant Retail could lead to extended period of losses

3. JD may choose to buyout Dada's minority shareholders in the future at a low price

At $1.3 share price, Dada has an MCap of RMB2.5bn and EV of -RMB280m. Normalised profitability is still difficult to assess but based on some conservative assumptions: FY24E revenue, GAAP OPM: 5% JD Now and 10% Dada Now (may have exceeded this already), zero interest income and 20% tax rate, then normalised FY24E GAAP NPAT is ~RMB600m. That's ~4x P/E with top-line growth still scaling up.

Alternatively, consider that FY25E, Dada Now segmental GAAP EBIT is estimated to reach RMB400-700m. As long as JD Now has any positive future value, almost any valuation assumptions you choose to use would indicate Dada is cheap.

Lastly, we note that new management have listened closely to our previous concerns. In December 2024, the board approved an increase to their 2020 Share Incentive Plan (previously 46m shares) of 52m additional shares which will be funded by share repurchases. Their annual stock issuance cap will more than double from 7m shares[1] to ~15.6m (52/6yrs = 8.6m pa). This means annual SBC value remains ~RMB150m (using $1.3 ADS price) and achieves the dual purpose of senior management interest alignment (maintains equity % of total salary value) and significantly boosts share buybacks (52m is ~20% of total shares on issue). We've also seen improving information disclosure and articulation of realistic expectations by the company with further clarity this year as the new management team takes stock of their first year turnaround efforts for JD Now operations.

We had made mistakes with our investment in Dada previously. However, the facts today support giving Dada more time to prove its value. If the company can scale its JD Now business to critical mass, then the upside is significant. We are cautiously optimistic.

[1] 2020 Incentive Compensation Plan is a 10year plan with 45.7m shares in total authorised. Additionally, there is an annual increase of 1% of total shares. So 45.7/10+(1%*264) = ~7m ADS pa

Portfolio Overview

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Top Five Major Holdings (in alphabetical order)	
Dada Nexus	E-Commerce
Full Truck Alliance	Logistics
JD.com	E-Commerce
Sands China	Casino
Wynn Macau	Casino

Performance	
Annualised Net Returns in US$[1]	
Since Inception (Jan 3, 2022)	-5.7%
1 Year	-13.0%
Non Annualised Net Returns in US$[1]	
3 months	-18.6%
6 months	5.6%
Net Returns By Year in US$[1]	
2024	-13.0%
2023	-27.8%
2022	33.4%

1. Net of 1.5% annual management fee and 20% performance fee (excess return above 5% hurdle rate and subject to HWM)

6:32
5G 76
波司登5折
首页
秒送
保利·大都汇
我的奖品
订单
库迪
搜索
咖啡
礼物
生日礼物
车厘子
玩具
库迪咖啡
大型超市
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大牌特价 悦享好物
领券立减30元
1元大牌
抄底价
更多
已补4.99元
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已补3.94元
¥2.56
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