



QUARTERLY COMMENTARY

31 December 2021

Manager Update: January 2022

John Qiu, Founder

Orlog Capital was fully funded and began operations in early January 2022. Although we are currently closed to new investors, we intend to release quarterly updates on our website. Our hope is for these reports to provide context and insights to our methods and performance. This is important given how different Orlog Capital is to other fund managers (see website for details of the Orlog model) and since we do not seek to manage short-term volatility. Therefore our investment results are likely to differ materially from industry peers and equity benchmarks which includes periods when we may significantly underperform. This is a natural part of our investment strategy and our pathway to delivering superior long-term performance.

The timing of our launch is interesting. For the past two years markets have not been normal and today's asset pricing is among the most extreme I've come across during my career. In one camp are the investments priced as if their best version of tomorrow was already true today, in the other camp are investments priced like a doomsday fire sale. Excessive central bank liquidity and a constantly changing roster of news events and interpretations – covid, inflation, geopolitics, etc is creating daily tsunamis of greed and fear in asset prices. At Orlog Capital we do not pretend to have the ability to predict the fury or even the direction of these waves. But individually, we like the risk/reward profile of many opportunities being offered today and we believe that as long as we stay afloat by not overloading on risk, the eventual payoff will be richly rewarding.

Our portfolio is based on bottom-up stock picking and we seek companies with strong risk-weighted return potential across all market conditions. Macro considerations do not feature heavily in our investment decision making process and is not our area of strength. However our studies of companies and industries give us certain insights and we occasionally form broader market opinions:

- Offshore listed Chinese stocks (US and HK listed) are very cheap - relative to global peers and in almost any macro environment setting. We believe the prospects for these companies to be far better than headlines or pricing would suggest
- Many oil & gas related equities are still overlooked. Some of these companies are trading on double digit to 20s type cashflow yields using sustainable cross cycle earnings. We think the market is still overly concerned on short-term demand fluctuation whereas we believe current energy prices is a reflection of long-term supply issues

We have found compelling bargains in both of these categories. Together, these positions account for 75% of the portfolio today and will likely rise further.

In this and all future quarterly reports we will write on one current investee company. For our first writeup we've chosen our largest investment position: JD.com.

About JD.com

JD.com is China's second largest e-commerce player and third largest globally by gross merchandise value (GMV). They have 550-600m active accounts (defined as at least one purchase over the past year) and sold >RMB3 trillion (>US\$450bn) worth of goods in 2021. Their business model is similar to Amazon in that the JD.com shopping platform sells both 1P (first party: JD direct to consumer) and 3P (3rd party: vendors to consumer) products. In the 1P business, JD.com's profit is the difference between the sourcing cost and the selling price of the good while for the 3P business they earn a commission cut of the sale.

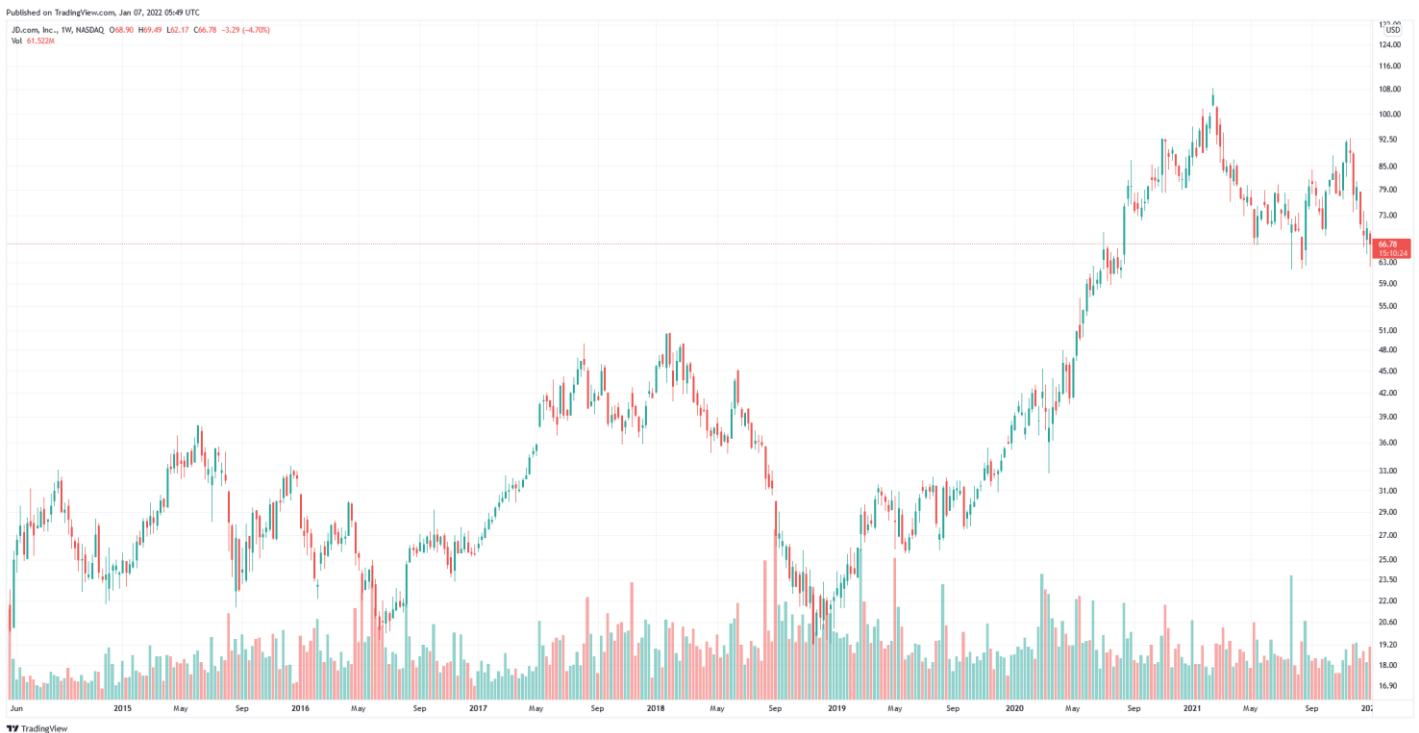
In addition to their main e-commerce platform: JD Retail, their major subsidiaries include: JD Health (internet healthcare platform), JD Logistics (logistics and warehousing), Dada Nexus (online/offline connected retailing and delivery), JD Digits (financial services). Most of this analysis will be concerned with JD Retail.

Historically the company has been a poorly understood and often hated investment. The below price chart shows JD.com hitting an all-time low in December 2019 despite growing sales 5x since its IPO in May 2014 and achieving (GAAP) profitability that year. A large part of the issue is the complexity on the accounting side specifically in these two major areas:

- **Online vs offline retailer accounting:** offline retailers grow by building new stores and capitalize these costs in Investment Cashflows. For an online retailer like JD.com, majority of their growth spending (e.g. discount prices, marketing, traffic) is expensed within the Profit & Loss statement
- **1P vs 3P accounting:** 1P accounts for all Rev and Costs (e.g. a \$100 gadget sold for \$110 shows \$100 in Cost of Goods Sold and \$110 in Rev) whereas 3P only accounts for the commission cut (e.g. a 5% commission on a \$110 sale shows just \$5.5 in Rev)

The implications of the above is normal unadjusted/face value operating and valuation metrics e.g. GPM, OPM, P/S, P/E, P/B, etc give a misleading picture both on an absolute basis and compared to peers (e.g. Alibaba, Pinduoduo are predominately 3P businesses). Also predicting near term profitability is a challenge given dynamically changing User growth decisions (e.g. price promotions during festivals). These are reasons why many investors compare it unfavourably to Alibaba and point to its low and sometimes negative profits as evidence of an inferior/failed business model.

Graph 1: JD.com (ADR) historical price chart



Source: TradingView

Business Model

This section will explain why consumers are attracted to JD.com, the strategy and structural advantages of its model, the self-financing nature of its growth and the rationale behind its investment in price (justification for losses).

Superior Retailing

Why consumers flock to JD.com is easy to experience and to understand - they're just better at delivering on the three key pillars of retailing:

- Price: meaningfully lower prices
- Convenience: transparent product reviews, easy mobile transactions, fast home delivery
- Service: quality guarantee, attentive customer service, generous return policy

Furthermore we believe JD.com's 1P business and the ownership/integration of its own logistics network gives it significant competitive advantages over most offline and online peers. Specifically:

- Greater accountability and control over product quality (important in China due to authenticity and safety concerns)
- Better delivery service: speed (same day usually and as low as 1hr), reliability (especially for valuable goods and high-volume sales/holiday periods) and efficiency (B2C logistics is generally more efficient than C2C)

Proof of JD.com's service quality is seen by the fast User growth, rising purchase rate and high market share in top tier Chinese cities (the most demanding consumer group).

JD.com	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Annual Active Accounts (m)	13	29	47	91	155	227	293	305	362	472
growth %		134%	62%	91%	71%	46%	29%	4%	19%	30%
GMV/Active user	2,616	2,502	2,648	2,677	2,739	2,843	3,098	3,845	4,033	3,875
% growth		-4%	6%	1%	2%	4%	9%	24%	5%	-4%

Note: Fast growth in new Users masks the strong rising purchase rate

Strategy

The JD.com model and strategy is based on disruption and replacement of offline retailing. With offline still at 70-75% of total China retail spending today, the conversion of these Users and their spending is still the major driver for growth.

JD's strategy is simple: start with one product category and price lower than offline whilst offering better service. This attracts Users and spending habits which drives up the purchase volume. The increased scale allows JD.com to negotiate better supplier terms, improve operational efficiencies which feeds back into price, service and scale in a virtuous cycle eventually allowing JD.com to dominant that category and marginalize/close down the competition. This disruptive process is repeated again and again in new categories of products (ideally standardised, low holding costs, fast turnover).

Often at the start of this process JD.com is losing money but this strategy is sustainable for two reasons:

- Negative working capital: the time to sell a product is less than the time required to pay the supplier. Sometimes this allows cashflow to be positive even when each sale is loss making – the supplier is basically bankrolling the growth
- Superior cost structure: discussed in later section

Combined together, it means small negative margins at low levels of sales (small losses) is rational as long as it leads to positive margins and significantly higher sales in the future (big profits). As long as this holds true, one should consider the early price incentives/losses as a form of investment.

JD.com's success in applying this strategy can be clearly seen by their financials which shows that in early years they incurred small losses but the multiplying effect on sales meant the later profits bailed out all past losses.

Their fast growth was completely self-financed as seen by the large positive operating and free-cashflows even during loss making years. The working capital table shows Acc Payable Days is significantly greater than Inv Days and Acc Receivable Days.

JD.com	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
RMB millions										
Income Statement										
Total Reported Revenues	21,129	41,381	69,340	115,002	181,042	258,290	362,332	462,020	576,888	745,802
Growth		96%	68%	66%	57%	43%	40%	28%	25%	29%
Normalised Operating Income	-1,404	-1,951	-579	-2,102	-3,128	-2,071	-1,672	-3,553	4,288	10,457
OPM	-6.6%	-4.7%	-0.8%	-1.8%	-1.7%	-0.8%	-0.5%	-0.8%	0.7%	1.4%
Normalised Net Income	-1,284	-1,729	-50	-1,296	-2,305	-1,550	-580	-2,486	5,907	11,490
Normalised NPM	-6.1%	-4.2%	-0.1%	-1.1%	-1.3%	-0.6%	-0.2%	-0.5%	1.0%	1.5%

JD.com	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
RMB millions										
Operating Cashflow (JD Retail)		1,404	3,639	3,767	13,701	17,200	29,054	13,512	20,547	42,592
Capex		-1,148	-1,292	-2,902	-5,300	-4,229	-11,356	-21,369	-1,094	-7,670
Free Cash flow to Core		256	2,347	865	8,401	12,971	17,698	-7,857	19,453	34,922

JD.com	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Acc Receivable Days	4.2	3.2	2.6	3.1	3.0	2.0	1.7	2.8	3.3	2.9
Inventory Days	49.8	35.7	32.1	32.9	37.1	39.9	40.8	40.0	38.7	34.7
Acc Payable Days 1P			42.2	40.9	44.6	52.0	59.1	58.1	54.5	47.1
Acc Payable Days 3P			42.9	21.9	22.5	19.0	17.4	13.7	9.7	10.0
Combined Acc Payable Days	65.5	55.7	55.3	51.3	59.3	65.0	69.6	72.1	64.6	58.6
Cash Conversion days	-11.4	-19.8	-25.6	-21.0	-27.1	-31.4	-33.6	-35.0	-28.8	-27.1

Structural Advantages

JD.com prices its 1P sales on average -10% below the biggest listed offline peers¹. This is estimated by comparing JD.com's 1P gross profit margin (GPM) to the blended GPM of offline peers.

Despite the lower pricing, JD.com catches up on operating profit margin (OPM) due to 3P commissions and its superior cost structure. This structural advantage is estimated by taking the OPM difference less the GPM difference. As seen by the below table, this number has been consistently trending upwards.

We are confident that JD's structural advantage vs offline peers and its operating margins will continue to increase based on:

- Rising GPM: from reduced price incentives as more product categories mature. When JD.com becomes dominant in a product category, less discounting is needed to maintain share of mind (e.g. electronics)
- Rising 3P sales
- Rising cost efficiencies in fulfillment
- Rising operational leverage in Marketing, R&D, Admin

RMB m	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
JD Retail: 1P GPM	4.4%	6.0%	6.7%	6.4%	5.3%	6.3%	6.1%	7.4%	7.0%	7.1%
Offline Majors: blended GPM	17.5%	16.3%	16.1%	16.1%	16.1%	15.4%	16.1%	16.8%	17.0%	14.2%
Diff: JD Retail minus Offline GPM	-13.1%	-10.2%	-9.3%	-9.8%	-10.7%	-9.1%	-10.0%	-9.4%	-10.0%	-7.1%
JD Retail: GAAP OPM	-6.6%	-4.7%	-0.8%	-1.3%	-1.2%	-0.5%	0.1%	0.4%	1.7%	2.1%
Offline Majors: blended GAAP OPM	4.9%	1.1%	1.3%	1.0%	-0.1%	0.0%	0.5%	-0.2%	0.2%	-2.9%
Diff: JD Retail minus Offline OPM	-11.6%	-5.8%	-2.2%	-2.3%	-1.1%	-0.6%	-0.4%	0.5%	1.4%	5.0%
GAAP OPM diff minus GPM diff	1.6%	4.4%	7.2%	7.5%	9.6%	8.5%	9.6%	9.9%	11.4%	12.1%

1. The peer sample used 1) Electronics/Whitegoods: Suning, Gome; 2) FMCG/Groceries: Sun Art, Yonghui. Margin blend is based on % sales by category on JD.com and within each category we use the average of the competitors

Another way to estimate the structural advantage is to directly compare the operational items as seen in the table below. Based on this method, the estimate for JD.com's advantage is ~9%.

In both methods, the 3P income is treated as an offset to costs similar to offline retailers renting out store space – both further the monetisation of traffic.

Offline Retail	% Rev^	JD Retail	% Rev
Occupancy cost	Suning: 3% Gome: 6.5% Sun Art: 2% Yonghui: 2%	Fulfillment	7.0%
Store running cost	Suning: 10% Gome: 9.5% Sun Art: 16% Yonghui: 15%	Marketing/Tech	6.5%
Wastage (expired Food items)	Sun Art: 2% Yonghui: 4%		
Opex+Wastage Average	Suning: 13% Gome: 16% Electronics Avg: 14.5% Sun Art: 20% Yonghui: 21% Hypermart: 20.5%	Total opex	13.5%
Less Rental Income	Suning: 0.5% Gome: 0.5% Sun Art: 3% Yonghui: 7%	Less 3P Income	7.5%
Adj Opex Average	Suning: 12.5% Gome: 15.5% Electronics Avg: 14% Sun Art: 17% Yonghui: 14% Hypermart: 15.5%	Adj opex	6.0%
Blended Adj Opex*	14.7%	Difference	8.7%
^Based on 2017-2019 average			
*55% Electronics, 45% Hypermart			

The real-world proof of JD.com's business model is seen by the deterioration of these offline majors and JD.com's own rising profitability. Today within the electronics/whitegoods category JD.com is the clear number 1 and they're now disrupting new categories of goods such as FMCG/Fresh foods. This later category is harder but existing offline majors are likely to continue weakening. By existentialist logic, a reasonable level of profitability will be achieved in the future though it will probably be hybrid online/offline models (majority controlled or fully owned by online majors).

The maths supporting JD.com's pricing strategy is shown below. This assumes the price incentives at the GP level directly affects growth. Based on this, roughly RMB1 of foregone profits has yielded RMB5-10 of additional GMV over the years. For example, in 2020 JD.com 'gave up' RMB50bn of profits via lower pricing which resulted in additional GMV: RMB370bn and Rev: RMB142bn. Applying a 4-7% OPM to the additional Rev equates to RMB6-10bn of normalized operating profits or an ROI 11-20%. This ROI estimate is low given the lifetime value of new Users and it doesn't estimate the impact to JD.com's other businesses.

JD.com	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Direct	29.8	56.7	93.7	159.3	255.6	372.3	510.5	619.9	785.7	1,002.9
Marketplace	2.9	16.6	31.8	83.2	168.9	272.0	395.6	553.8	674.0	825.9
Total Gross GMV (RMB bn)	32.7	73.3	125.5	242.5	424.5	644.3	906.1	1,173.8	1,459.8	1,828.8
Direct GMV growth		90%	65%	70%	60%	46%	37%	21%	27%	28%
Marketplace GMV growth		472%	92%	162%	103%	61%	45%	40%	22%	23%
Total GMV growth		124%	71%	93%	75%	52%	41%	30%	24%	25%
Foregone 1P profits (JD 1P GPM less Offline GPM)	-13.1%	-10.2%	-9.3%	-9.8%	-10.7%	-9.1%	-10.0%	-9.4%	-10.0%	-7.1%
Absolute value of GP foregone (RMB bn)	3.2	4.6	6.9	11.8	20.2	23.9	36.7	43.0	56.5	50.0
Absolute value of GMV gained (RMB bn)		40.6	52.2	117.0	182.0	219.8	261.8	267.7	286.0	369.0
GMV gains/Investment Cost		8.8	7.6	9.9	9.0	9.2	7.1	6.2	5.1	7.4
GMV to Rev conversion	64.6%	56.5%	55.3%	47.4%	42.0%	39.5%	39.3%	38.2%	37.9%	38.6%
Absolute value of Rev gained (RMBbn)		22.9	28.8	55.5	76.4	86.7	103.0	102.3	108.3	142.3
OP: 4% OPM (RMB bn)		0.9	1.2	2.2	3.1	3.5	4.1	4.1	4.3	5.7
OP: 7% OPM (RMB bn)		1.6	2.0	3.9	5.3	6.1	7.2	7.2	7.6	10.0
ROI: 4% OPM		20%	17%	19%	15%	15%	11%	10%	8%	11%
ROI: 7% OPM		35%	29%	33%	26%	25%	20%	17%	13%	20%

Normalised Profitability/Valuation

Looking at just the JD Retail part of JD.com, we use estimated GMV and Rev growth in the mid-teens for the next few years. We apply two scenarios to estimate normal/sustainable profitability (once price discounting is at a mature level):

- Scenario 1: JD Retail OPM 4% (2% above 2020 OPM). Estimate of additional margin: 1% from 1P pricing increase, 1% from cost savings
- Scenario 2: JD Retail OPM 7% (5% above 2020 OPM). Estimate of additional margin: 2% from 1P pricing increase, 1% additional 3P contribution (mostly increased % GMV), 2% cost savings

In our forecasts we adjust the reported GMV down by 50% (30% product returns, 20% VAT) and apply 20% tax rate on Operating Profit to get Net Profit.

On this basis, at the share price of US\$68/ADR, we estimate an investor is paying:

- 12-22x earnings based on just the normalised 2022E earnings of JD Retail
- 9-15x normalised 2022E earnings of JD Retail after adjusting out the value of JD.com's major subsidiaries² from the Market Cap

We think our estimates and way of looking at JD.com is conservative. It could very well surprise on the upside in terms of growth, margins and its non-JD Retail operations. We believe this is a very cheap price to pay for a dominant and extremely well-run business in an attractive sector. Even without any revaluation adjustments, the stock price should compound at teens to 20s % driven by the structural growth trend.

2. Subsidiary valuation estimates: JD Health: 20% discount to Listed Value, JD Digits: 50% discount to last valuation round 6/2020, JD Logistics: 15% discount to Listed Value, DADA: Listed Value. No deduction is made for JD.com's equity investments (e.g. China Unicom, VIPshop, Farfetch, etc) nor its various financial assets

Top Five Major Holdings (in alphabetical order)

Alibaba	E-Commerce
CNOOC	Oil & Gas Exploration & Production
CVR Energy	Refinery
JD.com	E-Commerce
Spirit Aerosystems	Aerostructure Manufacturer

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