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November 14, 2019

Dear Partners and Friends,

During the last few weeks of the quarter, there was a noticeable change in the market's tone. Seemingly triggered by the failed IPO of WeWork, we saw a dramatic shift in the way public markets investors scrutinize anything that smells like rapidly growing, "tech-enabled" companies. Don't get me wrong… this is a big positive. Many of these companies (which I've named in prior letters), have questionable business models that require a magnifying glass to find a real sustainable monetization method.

Time Period	Hayden (Net)[1]	S&P 500	MSCI World (ACWI)	Avg. Cash Exposure[2]
2014[3]	**(4.92%)**	**1.29%**	**(0.91%)**	**55.22%**
2015	**17.23%**	**1.37%**	**(2.22%)**	**26.31%**
2016	**3.90%**	**11.95%**	**8.40%**	**26.03%**
1st Quarter	0.96%	6.07%	6.91%	18.75%
2nd Quarter	12.62%	3.09%	4.68%	13.16%
3rd Quarter	1.01%	4.48%	5.08%	13.66%
4th Quarter	11.64%	6.64%	5.73%	14.35%
2017	**28.22%**	**21.82%**	**24.35%**	**14.98%**
1st Quarter	6.61%	(0.76%)	(0.54%)	12.58%
2nd Quarter	5.69%	3.43%	0.30%	8.74%
3rd Quarter	(4.97%)	7.71%	4.42%	8.54%
4th Quarter	(21.03%)	(13.53%)	(12.78%)	9.91%
2018	**(15.44%)**	**(4.39%)**	**(9.15%)**	**9.93%**
1st Quarter	14.73%	13.65%	12.45%	5.10%
2nd Quarter	11.98%	4.30%	3.45%	3.70%
3rd Quarter	(6.02%)	1.70%	0.05%	1.58%
2019	**20.75%**	**20.55%**	**16.40%**	**3.44%**
Annualized	**8.90%**	**10.30%**	**6.84%**	**-**
Total Return				
1 Year	**(4.64%)**	**4.25%**	**1.52%**	**-**
Since Inception	**51.62%**	**61.39%**	**38.11%**	**16.79%**

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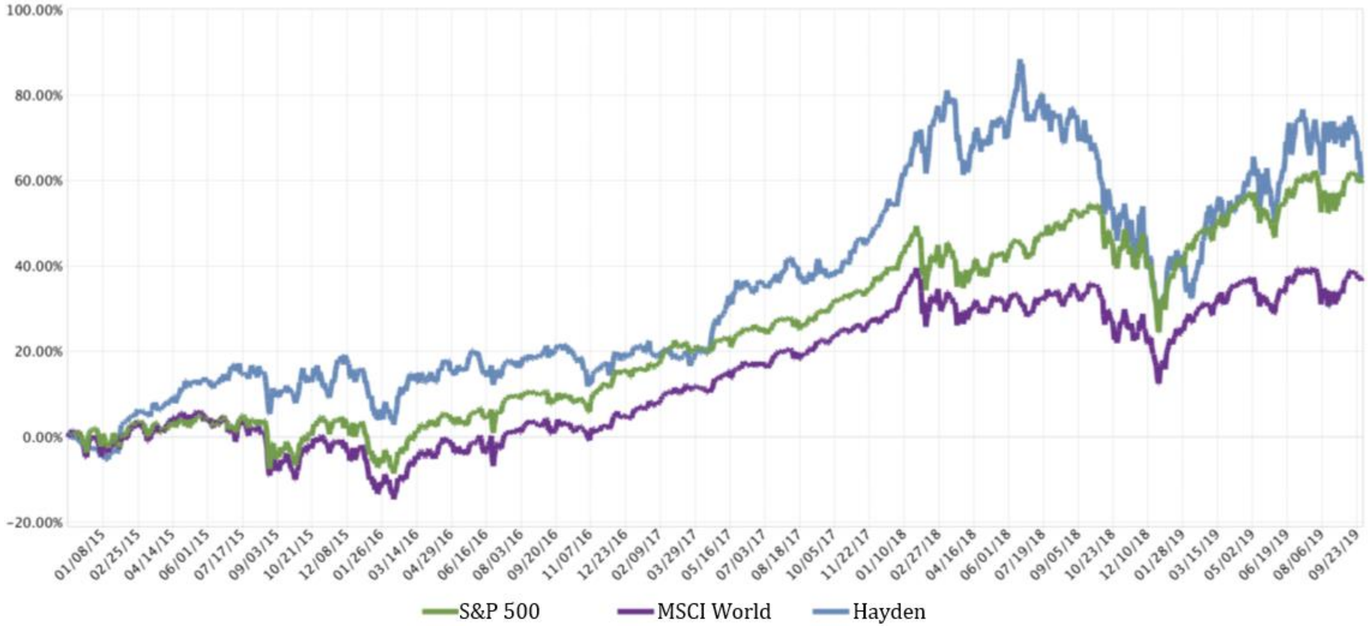
1 Hayden Capital returns are net of actual fees. Individual client performance may differ based on fee schedule and date of funding.

2 Includes cash and hedging instruments.

3 Hayden Capital launched on November 13, 2014. Performance for both Hayden Capital and the indexes reflects performance beginning on this date.

Performance Since Inception



If a company believes their market is one of "winner-take-all" (a term too often used these days…), from their perspective they may believe this behavior of aggressive spending is rational.

In economics, there's an game called "The Dollar Auction", whereby participants bid on a $1 bill, with the winner being the highest bidder (LINK). The catch however, is that the second-highest bidder also loses the amount that they bid.

Almost always, the end result is that the winning bid will surpass $1, as the bids rise and the bidders' incentives shift from trying to make a profit to minimizing their losses by not being in second place. It seems that is exactly what's happening in the case of some of these "disruptive" industries – with value leaking from the companies to elsewhere in the ecosystem, into the hands of customers or suppliers.

In the past few years, the private capital markets have been willing to fund these companies, providing the capital to make these ever-higher bids. However, as the stakes become ever larger and participants realize that they're approaching the $1 bid level, with no signs of opponents slowing down, the backers are getting cold-feet and unwilling to play the game any longer.

And when this sentiment shifts, the market shoots first and ask questions later (who has the time to analyze business models, when the entire sector is dropping a couple percentage points a day?).

However, there's a big difference between these recent IPOs versus companies like Sea Ltd (a Hayden holding) who are playing a far less aggressive game, or in certain segments are the only ones playing (see our Q1 2019 investor letter, LINK). The former companies are burning multiples of the revenue they bring in, while the latter is rapidly closing in on becoming cash flow positive as it levers growing scale against its fixed costs[4].

[4] Sea Ltd had ~-$50M of negative cash flow last quarter, vs. over ~-$220M the year prior, against $2.3BN in cash reserves and +140% y/y growth.

Nevertheless, some of our companies experienced a "baby thrown out with the bathwater" syndrome, and their stock prices traded down in the past few weeks.

Our portfolio was down -6.02% during the third quarter, vs. +1.70% for the S&P 500 and +0.05% for the MSCI World indices. Year-to-date our portfolio has gained +20.75% vs. +20.55% for the S&P 500 and +16.40% for the MSCI World indices. With the little cash we have left (along with proceeds from a sale, discussed below), I took the opportunity to add to these positions – evident in the 1.58% average cash exposure during the quarter.

Social Commerce – Shopping Under the Influence

If you've been following the retail space, you may have noticed a global trend dubbed "Social Commerce". The basic idea is that contributed by the rise of social media over the past decade, consumers are more trusting of their friends or influencers with similar tastes to themselves when making purchase decisions, versus a brand's own marketing message[5]. At its core, shopping as always been a social experience, especially for discovery or browsing type categories such as clothing, makeup, gadgets, etc. Social Commerce is the notion of taking this offline predilection and bringing it onto the web.

The term itself sounds gimmicky or like a buzzword made up by McKinsey. But the data proves that it's real. And we're starting to see those companies adopting elements of social commerce have an advantage vs competing platforms. So following on our Q4 2018 letter on "Super-Apps" and the competition for attention, I'd like to touch upon this aspect of social commerce, and its influence on shopping behavior.

As a starting point, the notion of social commerce has roots in social psychology. For example, a 2005 study by Prof. Luo found that the urge to purchase an item was far greater when shopping with peers (versus shopping alone or with family), especially if the peers are deemed similar to themselves. Studies from other countries have had similar results, indicating both that shopping with others leads to more frequent impulsive purchases, and that the tendency crosses cultural borders (a few examples: Link 1, Link 2, Link 3).

Impulsive Purchasing Behavior

"How Does Shopping With Others Influence Impulsive Purchasing?" (Luo, 2005) (LINK)

TABLE 2
Impulsive Urge and Impulsive Purchasing as a Function of Group Type, Group Cohesiveness, and Susceptibility to Influence: Study 2

	High Susceptibility to Influence				*Low Susceptibility to Influence*			
	Peer Group		*Family Group*		*Peer Group*		*Family Group*	
Condition	*M*	*n*	*M*	*n*	*M*	*n*	*M*	*n*
Impulsive urge								
Cohesive group	5.85_a	10	2.35_e	14	4.51_b	13	3.04_d	14
Noncohesive group	3.93_c	11	3.79_c	21	3.81_c	17	3.73_c	10
Impulsive purchasing								
Cohesive group	3.81_a	10	2.10_e	14	3.20_b	15	2.53_d	14
Noncohesive group	2.81_c	11	2.83_c	21	2.71_c	17	2.91_c	10

Note. Cell means with unlike subscripts differ at $p < .05$.

In the online world, companies like Poshmark are pioneering tools to take advantage these psychological habits. For example, the company, a pioneer in the second-hand clothing market, hosts events such as

5 Product reviews were the first iteration of this, and has since moved onto influencers and shared posts by friends.

limited duration virtual "Posh Parties", where shoppers with similar tastes meet online to shop and share items. Each Posh Party has a "host" (users submit an application to be selected) who then create a curated showroom of fashion items for their attendees, according to the party's theme.

Elsewhere on the platform, you can also follow the virtual closets of those sellers whose style & size match yours. This encourages you to regularly come back and see if your favorite seller has anything new that they're selling. For popular sellers (likely characterized by a combination of selling high-quality, low-priced, unique items), the "fun" is in spotting these items before other followers (typically there's just one item available, since these are resale items out of personal closets)[6]. This creates a "treasure hunt" type experience, which encourages users to regularly come back (similar to a virtual, personalized-to-you, TJ Maxx).

If you want to become a Poshmark Ambassador, you're required to share *thousands* of items from other Poshmark seller's closets, as well as sharing your own items thousands of times. In return, you get the benefit of access to exclusive events and more importantly, your store is promoted to new Poshmark users (and thus increasing your potential customer base). The app even has a built-in social feed, where other users and followers can see these shared posts / comment, and fosters an engaged community of users outside just a transactional experience.

Poshmark Daily User Engagement
Versus Facebook, Snapchat, and Instagram (LINK)

All this is with the goal to push users to find their "peer group" of like-minded shoppers. In turn, Poshmark's social commerce initiatives have driven them to have one of the highest user engagement rates in the industry.

In fact, the app rivals some of the world's most popular social media platforms in terms of capturing user attention. Whereas Facebook, Instagram, and Snapchat all have similar levels of ~27-28 minutes of average daily engagement, Poshmark captures an equally impressive 23-27 minutes of their users' time per day.

By keeping users engaged, it improves the user retention rates, and more importantly drives monetization. In categories such as fashion, where a customer likely doesn't know what he or she is looking for beforehand,

[6] High return rates are the one of the crucial flaws of selling clothing online, due to wrong sizes or difference in style when viewed online vs in person. By encouraging users to follow their favorite sellers, and continue to make repeat purchases from them, this is a very smart way to reduce return rates. Since you already know the seller is a similar size to yourself and have built trust on their style / quality of items over several purchases, the buyer is far less likely to return their items or have a poor experience.

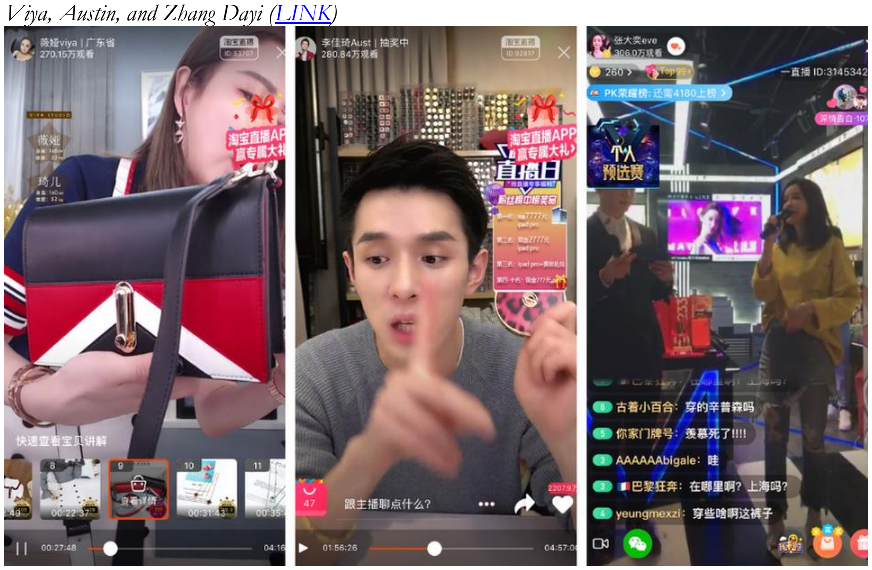
keeping them "in the store" and browsing as long as possible is important to finding something they'll eventually love. According to the company, 80% of Poshmark shoppers make repeat purchases and users open the app an average of 7 - 9x a day (LINK).

This has led to Poshmark controlling a marketplace that likely exceeds over $1BN in GMV[7]. This is impressive, especially when compared to competitors such as The Real Real, which specializes in the luxury segment. The Real Real is only expected to generate a similar ~$1BN in GMV this year, despite its average order sizes of ~$440 per order being an estimated ~7 - 10x that of Poshmark (indicating the strength / recurring nature of Poshmark's users).

In short, Poshmark's platform is driven by sticky, addicted users who keep coming back to the platform to interact with peers and buy items they didn't know they wanted, while The Real Real's is driven by occasional shoppers buying well-researched big ticket items (namely handbags, designer accessories, etc.) and only after comparing the items across multiple platforms. I'd argue that a platform with addicted users, making many small impulse purchases, is a more resilient and superior business model.

On the other side of the world, we can see similar benefits from Social Commerce. For example, Alibaba's Taobao platform was one of the early pioneers, launching features such as livestreaming, quanzi (online discussion groups for shoppers with similar interests), encouraging buyers to share photos of their recent purchases, and seller-chat functions.

Screenshots from Some of Taobao's Top Streamers
Viya, Austin, and Zhang Dayi (LINK)



Livestreaming, in particular, has been a standout success. Under the Taobao Live program, "wanghong" ("网红", i.e. internet influencers), celebrities, and even the everyday sellers / inventors of the product can live video chat with thousands or millions of their potential buyers (similar to a QVC or Home Shopping Network on steroids).

Instead of a relying on a static webpage to showcase the product, live streaming hosts interact with shoppers via video, answer questions, show the product in action, and make recommendations. Viewers can then purchase the product directly on the screen, without ever having to leave the stream. More importantly, hosts

[7] Poshmark is still a private company, with its official GMV figure undisclosed. However in 2018, they indicated the company was expected to generate $150M – 200M in revenue (LINK). Given that the company has a 20% take-rate, it implies the company generated $750M - $1BN in GMV in 2018. Users have continued to grow in the year hence, with our estimates that Poshmark has surpassed the $1BN level.

are building a "personal" relationship with their viewers, who often will come back to the platform just for entertainment.

So, does it actually work? Well in 2018, Taobao Live (the livestreaming segment) recorded sales of ~$15 Billion, which was a growth rate of ~400% from the prior year (LINK). Even still, the full benefit isn't captured in these figures, since users may login for a livestream but make purchases elsewhere on the platform.

Using these types of social features, Taobao has managed to capture users attention for 25 minutes a day, compared to Amazon's mere 9 minutes a day (LINK). More impressive, users launch the app an average of 7x per day (LINK). If anyone were to walk past the same store 7x a day, they'd probably be tempted to eventually buy something too…

"Actually, we tried to build up the connections not only between buyer and the sellers but ***also between buyers and especially the buyers with same hobbies and preferences****… They can comment with each other and they can share with each other. And this creates a lot of new demand from customers…* ***Taobao is more like a social commerce app rather than a marketplace.****"*

– Daniel Zhang, CEO of Alibaba (Q1 2017 Earnings Call)

"We observed from our consumers that ***ecommerce is the new window shopping****. When you are browsing the aisles of a store, you are looking to be entertained and delighted. When you have five minutes waiting for an elevator or for your friends, these are little pockets of time that we can fill. When you open your social field, you are looking to be entertained and delighted and that's what we want Lazada to be. While exploring the mechanics of this we found that* ***people crave being part of a group, community and to share good news…***

If people are coming in six times a day, we have to look at it from the perspective of customer life cycle management *and also an endless loop of community building. My focus now is on content creation. Every great relationship is about creating something delightful, surprising and highly personalized. And for us, that has to be done at scale. We have to give them a reason to come back. When I talk to my friends and our consumers,* ***they come almost every other day just to browse or play or see what's going on. Sort of like stopping at a mall on the way back home. Now, you can do it anywhere."***

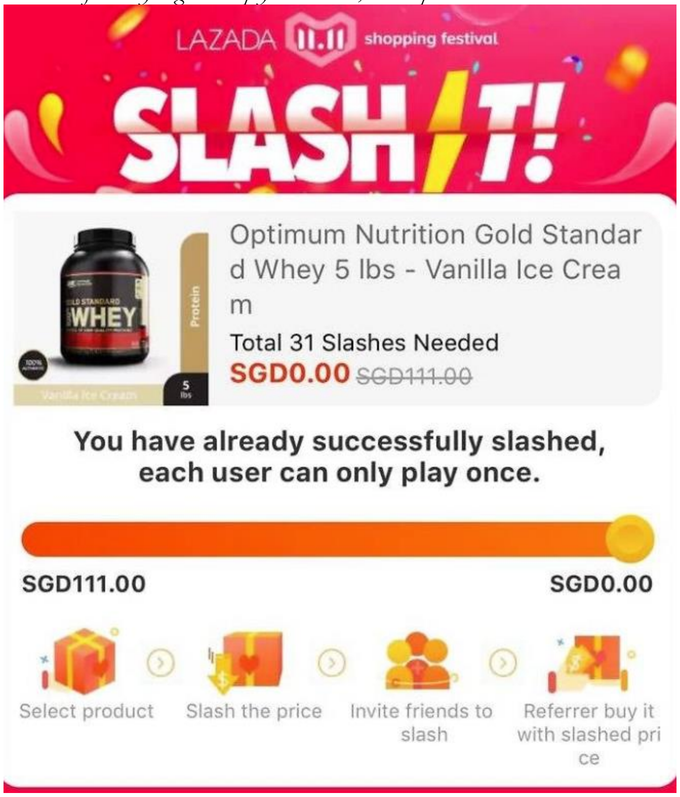
– Michelle Yip, CMO of Lazada Singapore (LINK)

Another feature these marketplaces have started using, is in-app games / gamification. One example is group buying, which involves sharing an item with friends on social media. The goal is asking them to "slash" the item (sometimes with a physical "slashing" motion with their phone), which then gives the referrer a discount on the item. The more friends they get to slash for them, the cheaper the item (sometimes even free).

From the platform's perspective, it's a cheap way to acquire new users, as well as utilizing "social proof" to encourage the friends to purchase the same item as well. At worst, it's an excuse to just get users to open the app more frequently (especially if many friends are regularly asking you to "slash" for them). Companies such as Pinduoduo (arguably the pioneer), Taobao, Lazada, Shopee, and many other Asian marketplaces have incorporated this feature.

Lazada's "Slash It!" Feature

The more friends you get to help you "Slash", the deeper the discounts



Shopee Catch Game

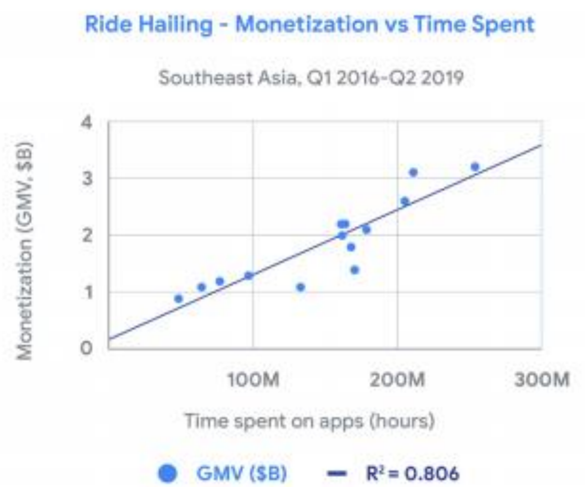
AR game where the goal is to "catch" the falling coins with the basket, on top of user's head.
Screenshot from YouTube ([LINK]*)*

Other features are straight-forward games, where shoppers play simple games to win vouchers or discounts to be used on the platform. These games tend to be more popular in Emerging Markets, where options for entertainment are generally more limited, daily time spent on mobile phones is higher, and these platforms are used for entertainment as much as for retail. Often these games will start during rush hour or at 9pm (in the case of "Shopee Shake"), when the companies know you're most likely to have your phone in hand.

So why am I wasting all this ink explaining initiatives that capture user's attention but don't generate a direct profit? Because time equals money… literally.

Bain-Google-Temasek published a report on the Southeast Asia internet economy last month (LINK). Within it, they show an analysis of the strong correlation (R^2 0.9) between the amount of time spent within an app, and the degree of monetization. Empirically, we've seen similar evidence when looking across platforms.

In-App Time Spent vs. Monetization
"e-Conomy SEA 2019" by Bain-Google-Temasek, (LINK)



Separately, the report makes the case that frequent online buyers in Developed Markets are less interested in spending time online (i.e. they want an efficient, "quickest to checkout" type experience). I disagree with this. Rather, I'd argue that developed market buyers just likely haven't had the opportunity to experience these types of social commerce platforms fully yet.

The business model gained popularity in Asia first, so entrepreneurs in the West are just starting to catch on. Additionally, these businesses need to be built from the ground-up. It's hard for existing platforms to pivot their business models, and change their cultural focus (For example, Amazon tried last year, and largely failed. Just take a look at their poorly advertised & executed Prime Day 2019 concert, with Taylor Swift (LINK). They were obviously trying to copy the success of Alibaba's livestreamed Singles Day 11.11 annual gala, but unsuccessfully (LINK)).

Businesses such as Poshmark also provide early signs that prove otherwise – that despite cultural differences, the benefits of social commerce are universal. And based on previous studies, human (shopping) psychology seems in-grained into our nature, resulting in my thesis that more e-commerce platforms will launch and follow this model in the West, and ultimately find success[8].

Broadly speaking, these types of datapoints are a useful "tool" in our mental model toolkit, when evaluating ecommerce retail businesses. As part of our research process, it's helpful to see what's working in other

[8] Note, this only applies to "discovery"-based categories of retail, such as fashion, cosmetics, home goods and the like.

geographies and recognize patterns that could be applicable in different countries. Our thesis is if you're able to take learnings from business models on two sides of the world, and recognize patterns far before other geographically siloed investors, that's a competitive advantage. At Hayden, I believe this a key benefit of our global portfolio, or "insight arbitrage".

Portfolio Updates

Credit Acceptance (CACC): We sold the last of Credit Acceptance this quarter, at an average price of ~$470. Partners will have already noticed our consistent trims over the past year, and using it as a source of cash to fund our other positions.

The investment has been successful for us, given our original purchase price of ~$140. But as the company grows larger and signs on more dealer relationships, I think the next five years will be tougher for the company's growth than the past five years.

We originally invested in the company when they only had 6.4K active dealer relationships. Our original estimates were that out of the ~45,000 independent used car dealerships in the country, approximately ~20,000 – 25,000 of those dealerships would be potential customers for Credit Acceptance.

The smaller addressable market, is because using Credit Acceptance's Portfolio Program requires a large commitment from dealers, including a $599 monthly program fee, needing to meet certain performance targets to get their dealer holdbacks, and having to buy car inventory tailored to meet Credit Acceptance's underwriting criteria. For example, dealers typically utilize Credit Acceptance because they think they'll make more on the loan on the backend vs. selling the loan outright to another lender.

Simplistically, Credit Acceptance gives 80% of remaining cash flows to the dealers after Credit Acceptance recoups its initial cash advance (which covers the dealer's initial wholesale cost + a small profit). So, if a dealer thinks the customer is credit worthy and more likely to pay off the loan, they will want to keep the loan for themselves, since the 80% residual can mean an extra $1K or more per car.

However, in order to receive this piece, called the "dealer holdback", the dealers need to meet performance targets, such as closing over 100 loans with Credit Acceptance, which are then cross-collateralized. If the dealer isn't able to meet this target, they forfeit all of their dealer holdback. On average, active dealers close ~30 loans per year with Credit Acceptance, and many churn off in the interim at ~9-12% a year. Because of this, the addressable market may be even smaller than at first glance, since thousands of dealers have already tried Credit Acceptance's program in prior years and determined it's not suitable for their business.

In order to mitigate this and expand its potential customer base, the company started ramping up its purchased loan program in recent years. This business is more akin to a traditional lender, in it buys the loans outright. In my opinion, it's a lower margin & higher risk (albeit still attractive) business line. Over our investment holding period, Credit Acceptance has increased this from less than 10% of total unit volume, to over 30% today (and still growing 2x faster than the portfolio loan business).

On top of this, since our initial investment, Credit Acceptance has grown its dealer relationships to close to ~15K, or a ~17% CAGR. The company and stock have performed extremely well during our ownership, but I suspect that may be coming to an end. The remaining pool of potential customers are going to be a tougher sell (there's a reason they haven't already joined the program), implying at most 60% upside in its dealer relationships. Volumes per dealer may increase (especially during a downturn when competitors retreat), but this is likely to be short-lived and will return to structural norms afterwards.

Given these dynamics, we've chosen to sell our remaining position. It's been a great return, at a ~26% annualized return since our initial investment. But with the company's mature stage and the need to focus on the purchase loan business line to continue growing, we've chosen to redeploy proceeds elsewhere.

Conclusion

We've moved! A couple weeks ago, I relocated our office into new space in Midtown Manhattan, at 1345 Avenue of the Americas. While I'm going to miss the coffee meetings at Tarallucci E Vino Nomad and passionately despise our new surroundings of suits and Patagonia vests in Midtown (yes, it really does look like this at lunch time), ultimately it was the right move.

The extra space allows us to take on two additional interns during the semester, and possibly expand the team in the future. A bonus is the nicer building, and at approximately the same price – aka upgrading the quality of our (office) portfolio.

Speaking of which, we're currently looking to hire 1-2 interns for the Spring semester. The ideal candidate would have some investing experience, an interest in our style of investing, and have the ability to speak an East or Southeast Asian language.

More importantly though, I'm looking for someone passionate about understanding why do countries, industries, businesses, ecosystems exist in their current form, and finding datapoints to "plug into" or challenge this ever-evolving view. Often this exists outside the pages of an annual report or tabs in a spreadsheet, so only creative and relentless aspiring analysts need apply.[9] Please send me an email if you or anyone you know may qualify.

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I just got back from Asia in late October, where I spent 3.5 weeks attending two conferences and meetings in Hong Kong, Shenzhen, Jakarta, Singapore, and Kuala Lumpur. In general, Asia is a relationship-based society, so it's crucial to visit often and build our networks, if we are to invest in the region. There's just so much information and level of detail, that can only be gained by meeting face-to-face – this latest trip reiterated that even further. If any of our partners would like to discuss notes from this trip privately, please reach out.

I'll be in NYC for the remainder of the year, so please drop by and pay us a visit. Even more so if you know of a good coffee shop near 55th Street and 6th Ave … I'll be buying. In the meantime, please email or call if there's anything I can help with.

Sincerely,

Fred Liu, CFA
Managing Partner
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[9] A former boss of mine used to say, "There's someone in the world who knows the information you want. As an analyst, it's your job to go find that person." At Hayden, it's something I try to remind myself daily, especially as the investing universe becomes ever-more efficient.

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