HAYDEN CAPITAL

QUARTERLY LETTER

2023 | Vol.2

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August 25, 2023

Dear Partners and Friends,

The past few months have provided some encouraging datapoints for the American economy. Inflation is on a definitive downtrend and is slowly returning to more normalized levels.

As a result, Volcker-style interest rates of over 10% (which some were predicting just a year ago) are now off the table. It's widely expected that we're already near peak interest rates for this hiking cycle – although how long they'll remain at these levels is a different question.

Time Period	Hayden (Net)[1]	S&P 500 (SPXTR)	MSCI World (ACWI)
2014[2]	(4.9%)	1.3%	(0.9%)
2015	17.2%	1.4%	(2.2%)
2016	3.9%	12.0%	8.4%
2017	28.2%	21.8%	24.4%
2018	(15.4%)	(4.4%)	(9.2%)
2019	41.0%	31.5%	26.6%
2020	222.4%	18.4%	16.3%
2021	(15.8%)	28.7%	18.7%
2022	(69.2%)	(18.1%)	(18.4%)
1st Quarter	21.5%	7.5%	7.4%
2nd Quarter	(4.8%)	8.7%	6.3%
2023	15.7%	16.9%	14.2%
Annualized Return	6.4%	11.5%	7.9%
Total Return			
1 Year	(1.8%)	19.6%	16.4%
5 Years	2.5%	78.7%	48.3%
Since Inception	71.4%	156.8%	93.3%

1 Hayden Capital returns are calculated net of actual fees directly deducted from client accounts, for the period from inception (November 13, 2014) to December 31, 2020. Starting on January 1, 2021, reported performance is reflective of a representative account, managed in accordance with Hayden's strategy with no client specific investment guidelines or limitations, made no subsequent investments or redemptions, and remains invested. The representative account paid a management fee of 1.5% and incentive fees of 0%. Clients who elect the performance fee option for their accounts may pay higher fees and therefore realize lower net returns, during years of strong investment performance. Individual returns may vary based on timing of investment and your specific fee schedule. Performance results are net of expenses, management fee and incentive fees. Past performance is not indicative of future results.

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

The US economy is still growing in the low single-digits, consumers are spending, and employment remains strong. With heightened confidence that the US is going to avoid another recession, the equity markets have been recovering.

Meanwhile in Asia, the economic picture is more mixed. Originally, China's economy remained resilient during the height of Covid, as the country essentially shut its borders over the last few years to prevent the spread of Covid, and the domestic economy was insulated from the global situation.

However as the country reopened up late last year, these economic consequences are just now starting to catch-up. China has so far avoided massive stimulus measures, fearing the same consequences of run-away inflation that the West has faced the past two years.

But as the economy remains in the doldrums, the government has started to shift its stance the past few weeks, with the economy's health clearly the government's top priority and more policy support expected for this fall. As such, after a volatile year, Chinese equities are beginning to recover as well.

As the situation remains dynamic, we're remaining cautious – only partnering with companies that provide necessary goods & services and on the right side of policy support, thereby allowing them to grow regardless of the economic environment.

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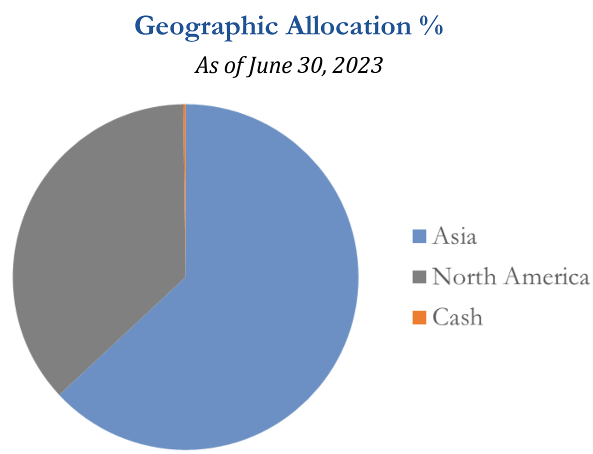

Our portfolio value declined -4.8% in the second quarter of 2023, versus +8.7% for the S&P 500 and +6.3% for the MSCI World indices. Our annualized return since inception is now +6.4%.

Due to the factors above, Asian markets have been volatile this quarter, and the recent declines were attributed to this segment of the portfolio. However, recent policy shifts & expectations for stimulus since the end of the quarter have resulted in our portfolio has already recovering these losses and more.

Markets remain fragile, and many factors can change in the near-term. But it just illustrates how volatile / quickly the prices the market is willing to pay can change these days.

At the end of the quarter, we had ~63% of our assets invested in Asia, ~37% in North America, and the residual in cash.

Fundamentals Still Matter (yes, even in China)

I spent an extensive period of time in Asia this quarter. In total, I was on the road for almost half the quarter, across two separate trips – first to Korea, and the second to Hong Kong and several countries in Southeast Asia. I've always found that there are certain aspects that can only be fully appreciated on the ground, speaking to contacts from a first-hand perspective.

These conversations may not be "scientific" or offer a robust sample set, but such anecdotes are still important. It's helpful to hear first-hand accounts, to provide context for the data we see behind our screens.

On this trip, the two most interesting insights I gathered, were both regarding how the US' increasingly contentious stance towards China (via tariffs & other restrictions) is affecting both neighboring economies in the region and investment sentiment in China itself.

Given all of the negative headlines surrounding the US-China trade war and China's slowing economy coming out of Covid, it's understandable why Chinese equities are trading at the lowest valuation in decades (LINK). This is especially acute among offshore listed companies (those traded in Hong Kong and New York), where capital markets are more open and incremental flows are predominantly driven by foreign investors.

After all, why would foreign investors invest their capital in a far-away market, with different consumer behaviors & cultural nuances, a difficult to understand political system, and language barriers? Especially when the current economy is struggling, and they can achieve similar rates of growth closer to home in the near-term?

Since most of China's offshore funds are based in Hong Kong, I tried to gain a better understanding of these factors on this recent trip, and whether such pessimism is warranted. Are investors' bleak views driven by a negative economic outlook, company fundamentals, government policy, or simply selling pressure from their US-based clients[3]?

Depending on the specific reason, will sentiment reverse once those issues are solved, or is investor confidence permanently impaired? Are investors fleeing because of poor stock prices? Or are poor stock prices driven by investors fleeing en masse?

After catching up with friends from close to a dozen of Hong Kong's largest hedge funds, my feeling is it's a combination of both.

Sentiment is likely permanently impaired. Across these conversations, it seems that many of these investment firms, who have built their investment businesses on Western capital, are now struggling for survival as their clients sour on investing in China. Performance has been tough for the past few years, and geopolitical tensions only complicate this further. Even reputable

[3] US Congress is considering a bill to prohibit government pensions from investing in Chinese equities, for example (LINK). Other institutions are already voluntarily avoiding such investments.

venture firms are struggling to raise new funds, with US dollar funding falling over -90% this year, versus two years ago (LINK).

There are also fundamental issues with the economy. The post-Covid reopening hasn't exactly been a V-shaped recovery as many were hoping. And the real estate sector is over-leveraged and will take years to clean up. With ~20% of China's GDP and ~70% of household wealth in real estate, declining housing prices have significantly dampened consumer spending (LINK).

But does that make the entire country and it's thousands of listed firms "uninvestable" (LINK)? Just a few years ago, international investors avoided South Korea and Japan as well, citing poor corporate governance and stagnant economies as popular reasons. And yet, one can find many companies that have generated multiple-fold returns for their shareholders during that time. So far this year, both of these markets have even witnessed a huge influx of foreign interest as well.

But what if valuations are at their lowest point in decades, not because of geopolitics, but simply because the country is growing at the slowest pace in decades? China's GDP grew at just 3% y/y in 2022, the lowest nearly 50 years (LINK). Combined with low visibility into what economic growth looks like in the near-term, is it surprising that valuations have followed suit?

Similarly at a company-level, Alibaba and JD both trade at ~10x P/E today. Meanwhile their GMV growth rates are estimated at ~7% y/y, only slightly above the overall economy. Both are facing disruption risk and market share losses to competitors, so the market lacks confidence that the situation can meaningfully improve. And with China having one of the most mature ecommerce sectors globally, and these firms' already high market shares, their results will become increasingly correlated with the broader economic picture.

Given this low-growth backdrop, the market ascribing a 10x P/E is understandable. It equates to a 10% yield for investors (while US 30yr government bonds yield over 4%). US companies that have similar competitive dynamics (low / no growth, facing disruption risks) trade at similar valuations. For example, IBM has traded ~10x P/E for most of the last decade, while media companies like Fox and Paramount who face disruption from streaming upstarts & resulting anemic growth, are also trading at the same valuations.

In a different example, we can also compare the returns of Meta (Facebook) and Tencent over the past five years[4]. Both are the US & China's largest social media companies, respectively, and facing increasing competition from the same competitor – Tik Tok.

During that time, Meta even similarly faced scrutiny from regulators (LINK). Both businesses have also had to adjust their business models, resulting in declining growth and margins. And yet, Meta's stock is up ~+63% during that time, while Tencent's stock is down ~-17%[5].

So how much of Tencent's stock under-performance is driven by its slower growth and lower margins (further hindered by China's weak economy & regulations), versus simply being penalized for being Chinese?

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[4] Arguably, 2017 & 2018 was the peak of positive sentiment for Chinese equities. The MSCI China index was up ~55% in 2017 (LINK), thus driving positive sentiment and headlines touting Chinese tech stocks "even hotter than FANG" (LINK).

[5] From Jan 1 2018 to June 30, 2023. Note, Tencent has also paid ordinary dividends and also special dividends (i.e. its JD stake), so the stock price doesn't fully reflect the total shareholder return.

If you compare Tencent and Meta's results since the beginning of 2018, you'll see their financial profiles evolved very similarly too. Both grew revenues by triple digits (Tencent's +164% vs. Meta's +222%), and exhibited similar revenue growth at the start (Tencent's +57% y/y in 2017 vs. Meta's +47% y/y). They're both expected to slow to ~12% revenue CAGRs over the next couple years also.

On the valuation front, Tencent's trailing EV / EBIT multiple declined ~-43%, while Meta's declined ~-20%. At first glance, this might seem like evidence of negative sentiment impacting Chinese equities.

But if you look at Tencent's starting valuation in early 2018, it was trading for 77% higher than Meta's (48x vs. 27x)! It's likely that investors under appreciated the magnitude by which both companies' growth would slow post-2017, and the greater reinvestment required as the competitive environment increased.

And with similar growth profiles expected over the next few years, it's not surprising that their valuation differences would converge over this time – with Tencent's needing to adjust by a greater degree. As growth slowed quicker than originally expected and earnings quality worsened, investors aren't willing to pay as much for each dollar of profit, as they were several years ago.

Given the data above, it strikes me that the majority of Meta's stock outperformance is simply explained by superior financial performance. Meta has grown profits ~39% faster, while margins for both firms compressed by a similar amount (~40%).

With all the negative headlines surrounding Chinese equities and the stock not generating any returns for over five years, one would have expected Tencent's results to be more dire. But the company has still managed to compound profits at 8% annually.

Instead, it seems to be simply a case of starting valuations / expectations being too high, versus what the company ultimately grew at. In fact, Tencent still trades at a 27% *premium* to Meta[6].

So instead of blaming geopolitical tensions for investors' poor returns, perhaps international investors were just too excited about the China's growth profile several years ago, which didn't pan out. In Meta's case, the company simply outperformed Tencent, and as such the stock was rewarded proportionally.

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So if Chinese stocks still trade on fundamentals, and we believe are valued appropriately, where is the opportunity then? And why have we invested more in the country over the past year[7]?

In my opinion, this is where poor sentiment has an effect. While valuations remain efficient on a historical basis, I suspect the lack of analyst manpower is starting to affect the efficiency of *forward-looking* expectations[8].

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[6] Tencent is at 27.5x EV / EBIT vs. Meta's 21.7x. This could be due to investor viewing Tencent's dominant WeChat and Payments businesses as more defensible / durable than Meta's.

[7] Compared to just ~5% of assets at the end of 2021.

[8] For example, the market might be pricing 20% y/y growth, when actual growth is likely 50% y/y.

With the loss of interest by both foreign investors and offshore funds, there's also fewer individuals doing the detective work necessary to understand *future* growth profiles[9]. Just among the firms I spoke with, almost all have downsized their analyst teams (and some by half!).

So while companies might be valued appropriately on recent financials, we're looking for opportunities where the market has under-appreciated *future* earnings, and thus making today's valuations look cheap a few years from now. It's simply a less efficient market & we can have a bigger edge if we pick our spots carefully.

It's pretty easy to value a company based upon historical earnings and growth rates sitting thousands of miles away. In fact, algorithms do an even better job at this.

But what about understanding how aggressive a competitor plans to be over the next year? Or at what point will a company raise their prices, and what KPIs they're following to gauge the optimal time to do so? All of these factors affect *future* growth rates and margins, and require in-depth, on-the-ground efforts to uncover.

As such, it seems that the opportunity is finding pockets of opportunities, where the broader market is under-estimating what a company's *future trajectory* looks like. Even better, is when the future is going to look markedly different than its recent financial trends (i.e., a re-acceleration of growth / inflection).

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The point is, that fundamentals still matter (even in China). While the above is just a comparison of a handful of companies out of thousands, the examples used are considered proxies for their respective ecosystems and are some of the most well-owned stocks in their markets.

Thus despite the news cycle, it's still company fundamentals that drive stock returns over a longer time frame (in this case, 5 years). It's just that it may take longer for good news to be incorporated into stock prices. Even over the past year as US-China tensions have heated up and China's economy has deteriorated further, there are still many companies that bucked the trend and have grown both their earnings and therefore their stock prices.

For example, within our own portfolio, PDD's stock is up ~45% in the past year, while EDU's is up ~140% (we discuss this position further below)[10]. Valuation multiples have been relatively stable / declining during that time, which means that the price appreciation was driven entirely by stronger financial performance.

PDD's revenues are set to grow +40% y/y and profits +24% y/y[11]. EDU likewise grew revenues +64% and went from loss-making to steadily profitable, improving by +146% (48M RMB for Q4

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[9] Let's say a company is currently trading at 10x P/E. Through your primary research, you might think there's an 80% chance growth will accelerate soon, and the company should theoretically be valued at 20x P/E if it turns out to be true. In an efficient market, the stock might trade historically at 18x, to take this new scenario / higher expected value into account.

But given the lack of analysts covering the situation, the market might miss that a growth inflection is coming. As such, the stock likely trades at 10x P/E, until the actual growth "prints" / there's evidence of it occurring in the financials. Instead of steadily rising to 20x over time in an efficient market, it suddenly jumps to 20x in a matter of weeks.

[10] As of August 17, 2023.

[11] Based on Q2 2023 sell-side estimates, since PDD hasn't reported earnings for the quarter yet.

2023 vs. -105M RMB in Q4 2022)[12]. It's simply a case of earnings being materially higher than they were a year ago, and the stock price following suit.

Obviously, in a tougher macro environment, it's even more important for investors to "pick their spots" carefully, since there's an economic headwind to fight against. Most companies are economically dependent, so the macro situation greatly affects their businesses. But companies that provide necessary products will always be in demand (value-for-money goods, and educational services, in the case of the above), and are more likely to continue growing despite such a backdrop.

We're not betting on the macro environment or that international shareholders will return. In fact, our going assumption is that the markets will behave similarly to the Japanese and South Korean markets a decade ago, before international investors became interested.

But as a bonus, based on my conversations in Hong Kong and with Chinese indices already trading near their lowest valuations in decades, I suspect that most of the valuation compression is already finished.

For investors, this means higher odds that the future stock returns will closely track the company's fundamental performance (without worrying about offsetting valuation compression headwinds). Given the growth some of China's leading companies will experience in the next few years, this earnings growth alone could offer investors some attractive returns.

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Something else that left an impression on this trip, is related to the trend of offshoring. While it doesn't directly affect our portfolio companies, it's fascinating to witness how geopolitical issues affect people on an individual level, and the unintended consequences of decisions made several thousand miles away.

Firstly, the trend of offshoring Chinese factories to Southeast Asian countries is indeed real. In fact, several of Hayden's partners in the region have built their family fortunes in manufacturing and are increasingly facing pressure from their customers to move their factories abroad.

The Western customers (i.e. brands) don't want to change their manufacturing partners, and risk disrupting their businesses. So instead of pursuing relationships with local manufacturers and spending additional time training / building trust with new partners, many are simply asking their existing Chinese partners to move their factories abroad.

However, the consequences of this are surprisingly negative for all parties – the brands, factory owners, and even the Southeast Asian countries (whom you'd think would be beneficiaries).

To start, constructing a new factory costs millions of dollars. One factory owner told me that in Thailand, he is offering their Western brand customer the option to either subsidize the $10M USD construction cost upfront, or charge a volume-based additional X% per item made, for the next five years. Either way, this means that Western consumers will end up paying at least +5-10% higher prices to subsidize the additional capex.

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[12] EDU has a May 31 fiscal year end.

It doesn't get better for operating costs either. For example, while factory wages in countries like Philippines, Indonesia or Vietnam are ~50 - 75%% cheaper than that of Chinese workers, the final unit costs tend to be *higher* than those made in China[13]. Supply chains are far more efficient in China. Assemblers typically have access to factories that make the individual components for the final product located within a 30-minute driving range. This enables just-in-time delivery of components, reduces the degree of inventory on hand needed, and thus frees up working capital. If there's any issues, you can just call up your suppliers and they'll have a new batch to your factory within hours.

In the Southeast Asia, these same components might be made in a different city, country, or even back in China. Combined with poor transportation infrastructure, these logistical costs and the time wasted waiting for components to arrive (days / weeks vs. mere hours in China) result in higher operational costs that negate the benefit of lower wages.

Several Chinese factory owners also complained about how hard it is to find suitable local labor – most commonly about differences in work-ethic (which can be a harder-to-solve cultural mismatch), and lack of experience (which will be solved over-time, as offshoring continues and more factory jobs made available). China has been the "world's factory" for decades, and also has a large and experienced labor pool. These are hard to replicate in the near-term.

For brands, this lack of labor experience also manifests itself in lower quality products. For decades, these brands didn't need to re-inspect the products upon landing – trusting their Chinese manufacturing partners to guarantee quality. But when manufacturing in these inexperienced markets, the lack of experience means that products that might look okay coming off the factory line. During transit, they inevitably end up breaking and only discovered after arriving at the customer. This results in wasted materials and needing to order excess inventory to account for this breakage.

It's only with a well-trained eye and years of experience, that you'd be able to tell these subtle differences. As such, the brands themselves are under-going a learning curve in quality control – and incurring yet another layer of inefficiency by going with local manufacturers.

To solve this issue, Chinese factory owners are simply bringing over dozens of their managers & workers from their existing Chinese operations to Southeast Asia to work in these new factories, instead of hiring locals. This obviously isn't what local governments want. It's certain that more locals will be hired over time (and gain training / experience). But in the near-term, customer orders don't stop, and these factory owners are simply doing what any rationale business person would do – finding the quickest method for getting their new factories running, and the products made at the lowest cost.

As such, the local economies aren't benefiting as much as they could, since it's these Chinese immigrant workers who are getting the jobs instead of locals. The owners of these new factories are Chinese as well, which means that as soon as profits are made, the capital is exported back "home", instead of being "recycled" in the local economies.

In a recent Bernstein research report, they also corroborated this, quoting a Chinese merchant who discussed why he wasn't worried about US tariffs: *"You might have a solution where raw materials*

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[13] Chinese factory workers make ~$500 – 700 USD per month, while wages in Southeast Asian are ~$200 – 300 per month. Note, this varies greatly depending on country, city within the country, sector, and worker experience. As such, these are just rough estimates.

like fabric is shipped in bulk to Mexico, and Chinese factory owners build factories to assemble for shipment to the US"[14].

And this trend isn't just for the US. Brazil recently threatened to charge an additional 60% tax on cross-border shipments from China, in an effort to protect local sellers (LINK)[15]. So instead, Shein is building local factories in Brazil to circumvent this (LINK). It's another instance of "same owners, different label".

The only immediate benefit these local countries are receiving from offshoring is some additional tax revenue and a small consumption increase from these immigrants. While the real benefit of potentially up-skilling the labor force / knowledge transfer is still in early-stages and too early to tell if it can have a permanent impact on the local economies.

Additionally, I suspect this will make these local governments *more* beholden to China – the exact opposite of what the US wants. Afterall, it's *Chinese* companies that local politicians are hoping will provide the training, jobs and upskilling to advance their economies.

From a Chinese factory owner perspective, all these countries are relatively interchangeable. While there are nuances between offshoring to Vietnam vs. Philippines vs. Indonesia, for example (specific industry expertise, access to local raw materials, taxes, etc.), they all provide the same overall benefit - cheap labor, and a stamp that doesn't say "Made in China". As such these local governments need to court Chinese entrepreneurs to set up base there, or risk losing business to rival neighbors.

My bet is that this ends up forming stronger ties between China and its regional neighbors over time, instead of driving a wedge between them as the US hoped.

As a result of all this, the impression I left with is that not much has changed. It's still the same Western brands placing these orders. The new factory owners are the same individuals as the old ones. And with workers being imported from their Chinese operations, the labor force is the same as well.

The only change is higher costs for everyone involved and ultimately the consumer – simply to change the label from "Made in China" to "Made in Vietnam / Philippines / Indonesia".

Note: these are just my personal observations obtained during my travels, and may not be a representative sample set of the entire industry dynamic. There are certainly pockets of local manufacturers who are successfully taking new business from their Chinese counterparts. However, after a number of conversations with both Chinese and local manufacturers, I believe it's likely these observations are more applicable to the broader industry, than not.

If anything, the take-away is that the intention to offshore manufacturing away from China may not be as clear-cut as US politicians originally envisioned, and perhaps did not recognize the unintended consequences it would have.

[14] Bernstein. "Global Internet: Temu 102 – The smell of napalm in the morning." August 9, 2023.

[15] Note, this measure was later watered down, only affecting orders above ~$50.

New Oriental Education (EDU): We made a new investment in New Oriental last fall. Outside of one-on-one discussions with some partners, I've never discussed the investment in-depth before. The reason for this is that I simply because thought there wasn't much to say.

The thesis at the time was extremely simple – the company was trading below the net cash value on its balance sheet, while I believed the on-going operations would soon return to profitable growth. As such, I believed the market was being overly pessimistic about the company's future prospects, and the shares would re-value once the on-going education business returned to a surer financial footing.

Partners will notice that unlike a typical Hayden investment, this is more emblematic of a "special-situations" / event-driven thesis. Our thesis is dependent upon a specific catalyst & subsequent change in the market's perception, more so than the longer-term attractiveness of the company's operations. I expect our holding period will be shorter than our typical investments, for this reason.

So how did this opportunity come about?

We've been following the company for a number of years, as New Oriental was previously one of the most widely-owned stocks among Chinese equities. The company was the leader within China's after-school tutoring sector, with 9.7M students and 1,361 locations across all of China[16]. Revenues grew +25% y/y annualized from 2010 – 2020, and operating income at +18% y/y. These results meant EDU was one of the best performing stocks during that decade.

In China, these after-school tutoring programs are viewed by parents as an essential complement to the public school curriculum. Often public school teachers would even expect their students to have already "learned ahead" the curriculum via these programs, thus spending less time in the classroom covering the subjects for the first time. As such, children who didn't enroll in these programs were at a disadvantage.

However China began implementing broader industry-wide regulations in 2021, which created uncertainty around the after-school tutoring business model, and investors feared an existential crisis for the company & industry as a whole.

I wrote about the government's rationale for such a move in our Q2 2021 investor letter, so I won't rehash it here (LINK). But I'd encourage partners interested in the historical context for this decision, to re-read that piece. In short, it was enacted with noble intentions – to help ease the rising cost of raising children in China, the resulting low birthrates, and the problems of rising income inequality (where wealthier families have access to better educational resources, when education is traditionally a great "equalizer" for social mobility). But perhaps the method used to achieve these goals was too blunt.

[16] As of FY2020 (LINK). Enrollments include K-12 students.

Whatever the case, this resulted in a dramatic repricing of New Oriental's stock, from a high of $186 in December 2020 to a mere $8 by last March. The company was forced to close its K-9 academic tutoring business (high school and adult education remained), and its learning centers were cut in half to just 744 locations.

Shares went from trading at ~40x earnings, to trading for *less than half* the value of *net cash* on EDU's balance sheet.[17] It went from investors viewing it as a durable franchise consumer-staple (i.e. viewed as a low-risk, bond-like proxy), to a deeply distressed situation.

Obviously, the market's fear was that as EDU restructured its business, it would need to continue eating into this cash balance, since the company still needed to pay leases and meet payroll. The business was losing ~-$270M per quarter in early 2022.

And yet under the hood, New Oriental's management had pulled off a remarkable turnaround. The team launched several new business-lines, such as non-academic tutoring (classes like robotics, coding, presentation skills, arts, sports, etc.). They even launched a live-stream ecommerce business under its Koolearn subsidiary (now renamed East Buy; LINK) originally as an effort to save thousands of their teacher's jobs. But the charisma of their teachers, and the unique format (hawking products, while simultaneously teaching viewers English) proved to be an unexpected hit. That subsidiary alone is now valued at ~$5BN on the Hong Kong exchange (LINK).

By the middle of last year, it was clear to us that the situation had already stabilized and the company was ready to resume growing again. Management also confirmed this on their earnings calls, even stating that the business would become profitable within the next quarter (and thus eliminating the market's fear of the company needing to tap into its cash balance further). But investors were slow to react, and the shares hadn't fully priced in this scenario yet.

For example, here are a few key quotes from their Q3 2022 earnings call (LINK)[18]:

> *"With the process of* ***school closure now largely completed****, it signals that the company has now entered stage of starting fresh, exploring new opportunities with greater flexibility and strong cash flows. We're* ***confident that in the sustainable profitability*** *of the all the remaining key business…*
>
> *As a stage of the closure of the schools and learning centers* ***nearing its end****, we're left with a relatively small portion of the lease terminations to be executed in the coming months…*
>
> *Our strong performing* ***key remaining business are all profitable*** *and will continue to serve as a solid foundation for business performance that will provide us with the fuel to explore new possibilities in the market.*
>
> *We have great confidence that the* ***overall business will turn profitable again in the near future****."*

By their Q4 2022 earnings call, management was guiding for the business turning sustainably profitable the following quarter and for the full-year:

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[17] EDU's market value reached just $1.4BN (at its $8.40 low), compared to the ~$3.4BN of net cash it had on its balance sheet.

[18] EDU has a May fiscal year end. So the Q3 2022 earnings call was conducted in April 2022, and referred to the quarter ending 2/28/2022.

"We are confident that we will ***achieve turnaround and profitable in the first quarter*** *as well as achieving* ***operating profit in the full year of 2023 fiscal year****."*

We are now taking all kinds of operational actions to promote our key remaining business and cautiously investing in new business, which will be the ***new growth engines that accelerates our recovery and to seek profitable growth.***

On July 26, 2022, New Oriental's Board of Directors ***authorized the repurchase of up to $400 million of the company's common shares*** *during the period from July 28, 2022, through May 31, 2023."*

Additionally, the board of directors backed this confidence with a $400M share buyback (~11% of total market cap and ~145% of the enterprise value, at time of announcement) (LINK).

By that point, it was obvious the company had successfully adapted to China's new after-school tutoring regulations, had stabilized its business, and was set to start generating profits again.

The stock price appreciated from ~$9.75 after the Q3 2022 call to close at ~$29 the day after the Q4 2022 call (a ~$1.4BN enterprise value). While this gain is impressive, EDU was still valued at just ~40% above the company's net cash balance.

In comparison, the situation was significantly de-risked given the new information, and we had a better idea of what New Oriental's business would look like in this new regulatory environment.

The industry is also consolidating to the largest players, since thousands of smaller tutoring centers didn't have the capability to adjust to this new regulatory framework and therefore shut down. But education is an important pillar of Chinese culture, and parents continue to seek additional educational programs for their children – regardless of whether it's academic or cultural programs. This means the companies left standing (especially those with well-known brands) are set to take a bigger piece of the industry than before.

I believed that given these factors, the stability of the remaining legacy tutoring business, and combined with the early success of their new initiatives, the business could generate over $500M in free cash flow by FY2024. If that occurred, it would equate to a ~37% FCF yield on the business' enterprise value by that point. And with a share repurchase plan already announced, it's likely that the excess cash will be returned to shareholders in time – thus providing support for the valuation and reducing a drag on the company's overall ROIC metrics[19].

After the initial excitement post-earnings, the share price moderated in subsequent months and we used that window to acquire our initial stake. We were able to purchase shares ~10 - 20% above the company's net cash balance, equal to a share price in the low $20's.

EDU's share price has appreciated another ~140% in the past year. But what's more interesting, is that forward valuation multiples haven't expanded – the return is driven entirely by higher fundamentals.

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[19] The cash balance is deposited in RMB and USD bank accounts and money market funds, which generates a low single-digit interest rate return, versus the core business operations.

For example, last year the street was expecting EDU to generate ~$200M FCF in three years (FY 2025). Nowadays, sell-side is expecting ~$800M FCF in three years (FY 2026)[20]. As such, the three-year forward EV/FCF multiple has stayed the same at ~7x, despite the company's brighter outlook[21].

EDU's highest annual FCF was ~$700M in 2021, before the regulatory changes. If it manages to achieve these 2026 expectations, the company will therefore surpass its prior highs and be in the strongest financial position in its 30-year history.

Going back to earlier, I believe it's also a good example of what I described above – whereby overall Chinese equity valuations will likely remain subdued in the current environment. But there are still select companies that exhibit strong (and under-appreciated) earnings growth, which can drive attractive shareholder returns.

Sea Ltd (SE): It's been a tough stretch for SE's stock price, as the company continues to adapt its strategy over the past year.

Two years ago, the company was growing its top-line at triple-digits, and every business was seemingly firing on all cylinders. But as market conditions changed and countries reopened from Covid, this put the brakes on all of Sea's business lines. I've talked about these events extensively in prior letters, so partners can review the historical context here (please see our Q3 2022 and Q1 2023 letters).

But as mentioned in our prior letters, I believe Sea's team has done a remarkable job of stabilizing the business. The company has gone from losing ~-$900M a quarter (Q2 2022) a year ago, to now making ~+$300M per quarter (Q2 2023)[22].

Given this, it's surprising shares are now trading ~-40% lower than where they were a year ago – versus when the company's potential bankruptcy was a real point of debate for investors. Obviously, this scenario didn't occur, since the company now has ~$7.7BN of cash and equivalents at its disposal (~$5BN net cash), and has proven it can generate >$500M free cash flow *per quarter*[23].

It's true these improvements came at the expense of revenue growth slowing from +29% y/y to +5% y/y. But its market share has remained relatively stable as well, with Shopee commanding ~40% market share in Indonesia, and ~57% in the rest of the region. Personally, I believe a category leading company that's on a stable / self-sustainable financial path is more valuable than one that's at risk of running out of cash, regardless of how high growth rates are.

But just last week, the company reported its Q2 2023 earnings results, and the stock dropped ~-30% immediately afterwards. So what's changed, and why does the market seem to disagree?

[20] According to Tikr.com. As of August 20, 2023.

[21] Note, the reason the share price hasn't matched increases in FCF expectations, is because of EDU's large cash balance. Since cash is logically valued at 1x, this has been a drag on EDU's overall returns.

[22] GAAP net income

[23] Sea Ltd has ~$3.3BN of convertible debt, that trades at 82 cents on the dollar. I've adjusted the net cash balance to reflect these mark-to-market prices (i.e. how much it'd cost SE to repurchase the bonds in the open market today).

Most of the market's angst seems to hinge on a particular comment during the earnings call (I've seen the same quote in multiple sell-side earnings recaps). Sea's founder, Forrest Li, stated:

> *"We have started and will continue to ramp up our investments in growing the e-commerce business across our markets.* **Such investments will have impact on our bottom line and may result in losses for Shopee and our group as a whole in certain periods.** *However, this does not change our unwavering emphasis on self-sufficiency and improving cost efficiency as a key competitive mode."*

A return to the loss-making days was not what investors wanted to hear. But also did the market really expect the company to remain in "cash-harvesting" mode, when regional ecommerce penetration is still low (~15% on official retail data, and even lower when including informal transactions) and the company still has a lot left to build in its ecosystem's infrastructure (i.e., self-owned logistics)?

At the heart of it, the market is worried that this recent pivot is primarily a defensive move, in reaction to TikTok's regional ascent this year. The fear is that Shopee is going to spend all its profits, just to stand still. Perhaps this increased investment is structural (i.e., recurring), something perpetually required to keep competitors at bay. If so, this decreases the long-term margin expectations for the business.

So was this a defensive move, or was it Shopee striking a competitor while there's a window of opportunity? I think it's a mix of both.

The move was certainly a reaction to TikTok Shop, but perhaps not as defensive as the market thinks. In fact, according to alternative data sources, TikTok's GMV has slowed down considerably – from ~10% m/m growth in Q1, to just ~3% m/m growth in Q2. Additionally, the company is raising commissions – notably in its most successful markets of Indonesia (37% of regional GMV), Thailand (23%), and Vietnam (17%).

TikTok Shop – Seller Fees

Source: Goldman Sachs

Exhibit 16: TikTok Shop: Seller commission rates & fees

Updated as of Jul 2023	Total seller commission	Prior to change	Effective
Indonesia	1.9-4.3% *change to category-based comm structure	1% + Rp2k fixed fee per order	1 Jun 23
Thailand	4% commission + 3% transaction fee (min. Bt12 per order)		
Vietnam	2% commission + 3% transaction fee	No commission (only 3% transaction fee)	14 Jul 23
Singapore	1% payment fee		
Malaysia	2% commission		
Philippines	2.2% transaction fee	2% transaction fee	1 Jun 23

Source: Company data, Data compiled by Goldman Sachs Global Investment Research

Shopee – Seller Fees

Source: Goldman Sachs

Exhibit 14: Shopee: Seller commission rates & fees

Updated as of Jul 2023	Commission Fee: Shopee Mall (B2C)	Commission Fee: Shopee Marketplace (C2C)	Payment Fee	Prior to Change	Effective
Taiwan	3.5-8.5% (3.9-9.4% if opt in for free shipping/cashback program)	5.5-6.5%	2-5%	B2C: 3-7% (or 3.4-7.9%) C2C: 4-5%	1 May 23
Indonesia	2.5-6.5% ("admin"), 1.8% ("payment") + 4% if opt in for free shipping program, 1.4% for cashback program	3.3-4.7% for star sellers (+ 4% to join free shipping program) / 2.8-4% for nonstar sellers (+ 4% to join free shipping program) + 1.4% if opt in for cashback program	0-10%		
Thailand	4-6%	3.2-4.3% + 5% if opt in for free shipping program, 3-4% for cashback program / 6-7% for both programs	3.2-6.4%	3-6% payment fee	1 Sep 23
Vietnam	1.8-7.7%	3% if not under any program / 6.5-7% if opt in for free shipping (8.5-9% for plus version), 4-5% for cashback program	3.0%		
Philippines	3.4-6.7%	3.5-5% for sellers not under any program / 2.5-4% + 5.6% if opt in for free shipping program, 3.4% for cashback program	2.2%		
Singapore	3.2-5.4% + 2% if opt in for free shipping program, 5.4% for cashback program	2% + 2% if opt in for free shipping program, 3.2-5.4% for cashback program	2%	B2C: 3.2% cashback program	1 Jun 23
Malaysia	5-9% (2-9% for FMCG)	3-4% + 5% if opt in for free shipping program, 3% for cashback program / 8% for both programs	2%	3-5% freeship program / 7% for both	Announced 3 Jul 23
Brazil	N/A	14% +R$2/item for regular sellers (+R$5 for CPF sellers) + 6% if opt in for free shipping program	Included in commission	14% + 6% if opt in freeship program (no fixed fee)	1 Jun 23
Mexico	N/A	14% (8% promo rate for local sellers)	2-3.5%		

Source: Company data, Data compiled by Goldman Sachs Global Investment Research

Additionally, we can look at Douyin (TikTok's Chinese app) to offer some clues about how big a threat livestream ecommerce really is. For example in 2022, Douyin grew its GMV ~+80% y/y to RMB 1.4 trillion, slowing from +200% growth the year before (LINK). While this seems like a large number, it's just ~11% of the total ecommerce market.

In fact in early 2022, the company internally thought that the livestream GMV ceiling is only 2-3 trillion RMB (low-20%'s penetration), and it would reach this level in the next two years (LINK). It looks like the real "ceiling" might be higher given recent performance but is likely still within the ballpark. This is also why TikTok Shop has been expanding overseas in search of new growth markets too.

So far in 2023, it seems like Douyin's growth is slowing, albeit at a still impressive ~40% y/y. GMVs should breach the low-end of their internal ceiling this year, at over RMB 2 trillion. But looking towards 2024, this growth is expected to slow even further, to ~22% y/y, as livestreaming GMV penetration approaches its natural ceiling.

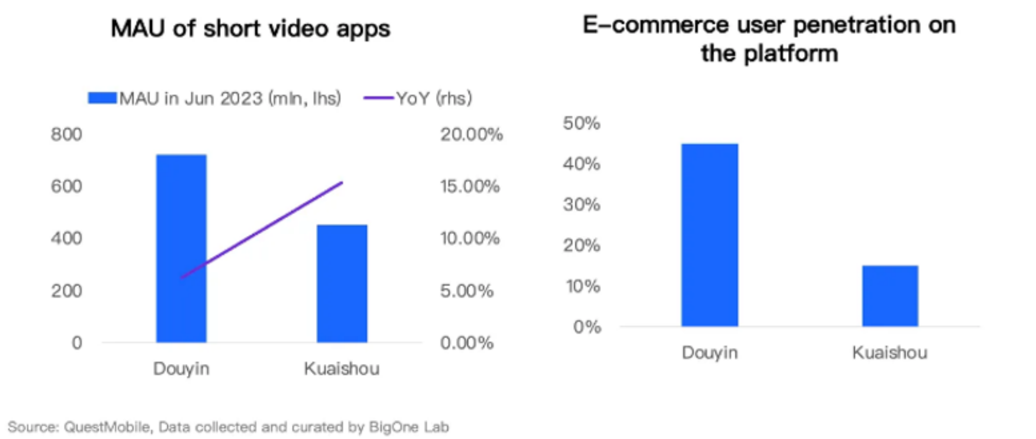
The issue is that 45% of Douyin users already use the shopping function, and monthly active users are only growing 6% y/y. There is only so much more that their existing users can spend on the platform, and there's few potential new users left in the market. ~68% of China's mobile internet user base already has a Douyin account[24].

Combined with Kuaishou (another short-form video competitor), it looks like 2023 livestream ecommerce penetration should reach just over 20% this year (with Douyin capturing ~15%).

[24] Douyin has ~750M users, versus a total 1.1BN mobile internet users (LINK).

Douyin (TikTok China) MAU & Ecommerce Penetration

Source: Baiguan ([LINK](#))



We also haven't seen any evidence of a subsidy war in Southeast Asia – at least to the degree we saw between 2019 – 2021. Instead, the competitive environment continues to *rationalize*, with both Lazada and Tokopedia raising commissions as well.

In fact, all of these markets now have commission rates approaching Shopee's. If TikTok wanted to be aggressive and was intent on buying more market share, why not wait to raise commissions and grow GMV even faster?

Perhaps it's because Bytedance is known for targeting profitability on any new business, within 3 years of launching (TikTok Shop Indonesia launched in early 2021).

Or maybe as they gear up for their US expansion this month (a much larger market), they're aiming to fund this expansion with SE Asian profits (LINK)? The Information reports that TikTok Shop is on track to lose ~$500M to launch its US business, for just 4 months of operations (LINK). This should accelerate into several billion next year, as GMVs (and thus subsidies) increase.

Or maybe it's because the Indonesian government is planning to ban cross-border sales below $100, which would derail TikTok's ultimate goal of selling inventory directly from China (LINK)[25]? TikTok is private and doesn't give any disclosure, so it's hard to know for sure.

But I'd venture to guess the real reason Shopee chose to reinvest now, instead of earlier this year, is that they sense a window of opportunity to take back users from TikTok. I heard that previously, Shopee wasn't concerned about TikTok Shop's growth, since they were acquiring price-sensitive, low-value users. These are customers that Shopee couldn't make a profit on, under its current model.

But TikTok is acquiring *too many* of these low-value users, which is affecting how merchants treat TikTok. At the end of the day, merchants only care about getting more orders. They don't care

[25] Note this also makes it highly unlikely that Temu will enter Southeast Asia (excluding Singapore).

how much of it is subsidized by TikTok, how much customer acquisitions costs are, etc. They just care that the orders they're getting today, are more than they were last week.

As such, the worry is that as TikTok makes up a greater percentage of merchant's orders, that these merchants will become more dependent upon TikTok's platform and therefore be more willing to accept higher commissions, even if it means a lower overall profit margin. If TikTok is only 5% of your orders and they raise prices, the merchant might say it's not worth the effort being on TikTok's platform (especially given the operational burden of recording / editing videos, managing another platform, etc.). But if TikTok is 25% of your business, you might be more willing to accept a price increase, since you're still making money from them, albeit at lower margins.

Getting a sizable base of low-value customers also affects logistics costs. Both Shopee and Lazada have been trying to squeeze their 3rd party logistics companies ("3PLs") over the past year. In fact, Shopee and Lazada now fulfill ~40% and ~55% of their orders internally.

Shopee & Lazada In-House Logistics

Source: Momentum Works

Shopee and Lazada use in-house logistics extensively

	Shopee	Lazada	tokopedia	TikTok Shop
Logistics and fulfilment model	1P: *Shopee Xpress* 3P	1P: *Lazada Logistics* 3P	1P: *GoTo Logistics, Dilayani Tokopedia* 3P	3P
Types of logistics and fulfilment facilities	> 6,000 Shopee Xpress service points, hubs, and agents	> 400 warehouse facilities, sorting centres, collection/delivery hubs	9 Dilayani Tokopedia smart warehouses	N/A
% of orders fulfilled by in-house logistics	35-40%	50-60%	<10%	0%

3PLs have been feeling the squeeze, with J&T offering a good example. For background, J&T is the logistics company founded by former Oppo executives, and are the primary logistics partners behind TikTok, PDD's Temu, Shein, and other Chinese cross-border players. In fact, Shopee helped build J&T, by providing order volumes to them to build scale, in the early days. I heard Shopee & Lazada even comprised over 50% of J&T's volumes at one point.

But if you look at J&T's recently filed prospectus, you'll see that Southeast Asia EBITDA has dropped from $427M in 2021 to $331M in 2022 (LINK). This is despite revenues remaining flat at ~$2.4BN, thus equating to margins declining ~-4% (from ~17% to ~13%). From our understanding, this margin compression has increased in 2023, as the major ecommerce companies continue to prioritize their own shipping services and J&T continues to subsidize TikTok Shop shipping fees[26].

To cover their high fixed costs, in a declining order volume regime, many 3PLs had to increase their shipping prices to remain solvent. This has increased the gap between Shopee's internal logistics rates vs. 3PLs, with internal logistics costing up to -80% less!

[26] ~90% of TikTok Shop Indonesia orders are fulfilled through J&T.

In-House vs. 3PL Shipping Rates

Source: Tech in Asia (LINK); Philippines only

Shipping rates* in the Philippines

Company	Shipping rates
Ninja Van	US$1.12 to US$2.05 (does not include rates from some islands)
J&T Express	US$2.14 to US$3.82
Flash Express	US$2.03 to US$3.71
Lalamove	US$0.91 (motorcycle), US$1.86 to US$1.90 (sedan), US$2.14 (multi purpose vehicle), US$6.34 to US$46.59 (truck)
GoGo Xpress	US$1.49 to US$3.35 (maximum of 3 kilograms)
Shopee Xpress (in-house)	US$0.71
Lazada Logistics (in-house)	US$0.71

*For packages weighing 0.5 to 1 kilogram
Currency converted from Philippine peso to US dollar: US$1 = 53.67 pesos.

TECHINASIA

So why TikTok's accumulation of low-value customers matters is that even if they're unprofitable, they're still orders. TikTok uses 3PLs for 100% of its orders, so this increased volume is now providing a lifeline to the 3PLs. If TikTok can make up for Shopee & Lazada's lost order volume, this could mean that 3PLs can structurally start lowering rates again and become more competitive. Even worse, they could get to a point where structural logistics is at a low enough point, where TikTok's formerly unprofitable customers are now suddenly viable.

So as Shopee continues developing its internal logistics unit and lowers its "cost to serve", it needs to keep these low-value users out of TikTok's hands in the meantime. This is likely why Shopee is stepping up its promotional activity, and encouraging use of its own Shopee Live video shopping platform[27].

It's going to take some time to see whether these investment activities are successful. As such, I'd expect investors to continue to debate these points and the stock to remain contentious / range-bound until early next year.

The big test is going to be this upcoming holiday season, with 9.9 / 10.10 / 11.11 / and 12.12 shopping festivals still on deck. This is the best time to acquire new users, since people already have the intent to shop, and many of these users will be shopping online for the first time. It's cheaper to acquire a new user and build brand loyalty from scratch, than to poach one from a competitor. Shopee needs to show evidence of pushing back the competition and for these reinvestments paying off in the form of higher growth, before investors regain their confidence.

So far, alternative data is showing some early success. According to these sources, GMV grew ~8% y/y in July, compared to an average of 0% y/y growth for the first half of the year. Even

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[27] Shopee Live was launched in 2019, but the company didn't make a big marketing push until now. Shopee claimed on its Q2 2023 earnings call that it's already "the leading live streaming ecommerce platform in Indonesia", with 1/4th of its Indonesian buyers watching its livestreams during a recent shopping event.

Note, Alibaba has fought against Douyin in China in a similar way, by launching Taobao Live. Taobao Live now comprises ~4% of total ecommerce GMV.

gaming is showing signs of an early turnaround. Garena's in-app spending has apparently grown ~+22% q/q so far in Q3, versus a -5% decline in Q2 and -8% in Q1.

It's early signs that the growth initiatives are working, but I caution it's only one month of data – we'll wait for a longer time series before we get too excited.

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On the valuation front, the company is now valued below replacement cost – so there's definitely more than a healthy dose of skepticism baked in. If we re-run the analysis that we originally showed in Q3 2022, the company is now trading at ~0.9x the total external capital that has went into the business. By implication, the market is saying that the entire business is worth less than the raw capital that was used to build it.

Sea Ltd Replacement Value

Source: Hayden estimates

Sources of Capital	**Q3 2022**	**Q2 2023**
Total External Capital	16,172,684	16,172,684
+ Garena Profits	7,358,459	8,086,206
= Total Funding	23,531,143	24,258,890
vs. Market Cap	32,000,000	21,000,000
= Return on Capital Injected	**1.4x**	**0.9x**
Use of Capital		
Cash	7,295,678	7,699,336
+ Shopee Sales & Marketing	7,694,177	8,843,714
+ Sea Money Loans Receivable	2,136,101	1,999,544
+ Research & Development	2,592,089	3,440,093
+ Other (incl. Shopee Merchant Subsidies)	3,813,098	2,276,203
= Total Capital	**$ 23,531,143**	**$ 24,258,890**
memo: Cash, as % of Total Capital	*31.0%*	*31.7%*
memo: Shopee S&M, as % of Total Capital	*32.7%*	*36.5%*
memo: Sea Money Loans, as % of Total Capital	*9.1%*	*8.2%*
memo: R&D, as % of Total Capital	*11.0%*	*14.2%*
memo: Other, as % of Total Capital	*16.2%*	*9.4%*

In fact, Shopee is now valued at just ~$3BN by the market. This assumes we value Garena at 5x EBITDA, which is a ~$5BN valuation (assumes the business is stabilized, but no growth). SeaMoney at 15x EBITDA is worth ~$8BN (given it's 53% y/y growth), and there's also an additional $5BN net cash. Subtract that from the current $21BN market cap, and you can see that there's little baked into today's price.

Additionally, Alibaba has injected ~$7.8BN into Lazada over the past seven years, only to achieve 1/3rd the scale of Shopee & remains unprofitable. Even TikTok said it plans to spend "billions" on its investment in Southeast Asia, and likely only reach a fraction of Shopee's scale (LINK).

In reality, according to Singapore's ARCA filings, TikTok's Southeast Asia division already lost ~$2.2BN in 2021, and another ~$2.7BN last year, for a cumulative ~$4.9BN. Cumulative GMV was just ~$5BN in this period (in addition to advertising and livestreaming revenues)[28].

Considering what they're spending already, I'm just not sure if the "billions" they plan to spend in Southeast Asia that's frequently cited in the headlines is necessarily "new" news.

Alibaba's Total Investment in Lazada

Total capital invested since acquisition

Alibaba's Lazada Investment	
Original Lazada Purchase (2016-18)	4,000
Alibaba Injection (June 2020)	1,300
Alibaba Injection (May 2022)	379
Alibaba Injection (Sept 2022)	912
Alibaba Injection (Dec 2022)	343
Alibaba Injection (July 2023)	845
Total	$ 7,778

I understand the pessimism around the increased competitive environment, but this seems extreme. The market is obviously worried that TikTok's rise will pressure Shopee into reinvesting its profits for a prolonged period of time. If a business can't ever make money, obviously it's not worth very much. If we believed this were the case, then our thesis would be clearly broken & the shares overvalued.

But we believe China provides an indication where TikTok's terminal market share might end up (~25%), and they're already showing signs of slowing GMV growth in Southeast Asia. TikTok's Southeast Asia business is already at the same penetration rates as Douyin in 2022. As such, we should see growth moderate further over the next two years, if trends follow TikTok's home market. TikTok raising prices in Southeast Asia and announcing aggressive plans in the US should tell you where their priorities lie. Chances are the worst is already over, and the competitive environment is going to become much easier in the next two years.

The incumbents have already spent tens of billions of capital, in their fight for the Southeast Asia ecommerce market. I'm not sure there's appetite for more, and all have already indicated a desire to realize a return on these massive investments over the past year via increasing commissions & cost optimizations. TikTok doesn't change this, and is in fact showing signs that it's starting to do so too.

It's been tough for Sea's stock price recently, but I just don't think the environment is as dire as the market believes. In fact, the competitive environment has gotten better over the last few years, not worse. Shopee remains the leader at ~50% market share and has maintained this despite drastic cost cutting and new competition over the past year.

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[28] Data from Singapore's ARCA database. Companies incorporated in Singapore need to file their financial statements with the government, which is available for public purchase (LINK).

TikTok did ~$0.6BN GMV in 2021, and ~$4.4BN in 2022.

The Southeast Asian ecommerce "prize" is a big one, and someone's going to win it. Shopee already fought against Tokopedia & Lazada (and from an under-dog position), and won. Now with a new challenger on the block, and Shopee attacking from a dominant position, I believe they can do it again.

The new reinvestments this quarter should help it further its lead, and we're already seeing early indications of these new growth investments paying off. We'll be watching closely, and investors should have a clearer picture by early next year.

CONCLUSION

The past few years have been volatile, to say the least. Not just for equity prices, but also for the business cycle itself – where a full cycle was compressed into a mere 3 years!

At a high level, there's just three factors that matter for most businesses – demand, supply, and access to capital. Consumer demand has been erratic, as the world was forced online in the midst of Covid, and then quickly shifted offline towards real-world services as economies reopened. Initially, this led our companies & their competitors to expand quickly, to meet this explosive demand.

But as consumer demand moderated, this left the entire sector over-supplied and required almost every company to "right-size" their operations. This phase dominated headlines last year, leading to the nimble companies drastically cutting headcount and trimming off tangential business lines. Those who couldn't were eventually forced to shut their doors.

On top of this, the rapid changes in the cost of capital exacerbated these dynamics. Typically, interest rates rise during periods of high demand (i.e., expansionary economies), since more companies seek out funding from a limited pool of capital and the Fed attempts to prevent the economy from "over-heating". But this is the exact opposite of what happened in the last few years.

Just as internet-based companies were seeking capital for their aggressive expansion, interest rates around the world *declined*, as governments tried to support the broader economy from Covid-induced damage. Companies were able to borrow at just 2-3% interest rates, lower than even the long-term rate of inflation.

Then just as the industry faced a slowing demand environment, interest rates rose to their highest levels in 15 years. The result was an even greater urgency to become self-sufficient and to cut costs / curtail growth plans aggressively.

It's been a unique period, especially for most of our companies for whom it's their first time going through a full business cycle. Most are nascent businesses, less than a decade old.

To use an analogy, they're teenagers – still in the middle of building out their ecosystems and competitive moats. Similarly, they required money from their "parents" (i.e., capital markets) to do so, before they could turn the assets / skills they developed into opportunities to make money for themselves, and eventually pay their parents back.

However, the past year forced many of them to "grow up" quicker than expected. It hasn't been a smooth journey, but we're proud of how they've managed to navigate this period. All of our portfolio companies are now fully self-sufficient (i.e. already profitable or will be shortly), thus no longer requiring access to the capital markets.

The good news is that it feels like we're finally entering a "normalized" period, where these macro dynamics are more balanced. The world has largely put Covid behind it, and households have returned to their old habits. Hopefully industry dynamics will continue stabilizing, and provide our firms with a more predictable environment to grow up in.

We're looking forward to this next phase, and watching what our businesses can accomplish in their "adulthood".

Sincerely,

Fred Liu, CFA
Managing Partner
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