HAYDEN CAPITAL

# QUARTERLY LETTER

2023 | Vol.3

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HAYDEN CAPITAL

November 25, 2023

Dear Partners and Friends,

Our portfolio rose in the third quarter, as several of our portfolio companies started reporting signs of growth reacceleration. The past two years were about cost-rationalization, as consumers slowed their spending post-Covid, and businesses found themselves over-built for this new environment.

| 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% |
| 3rd Quarter | 11.6% | (3.3%) | (3.7%) |
| **2023** | **29.1%** | **13.1%** | **9.9%** |
| **Annualized Return** | **7.6%** | **10.8%** | **7.2%** |
| **Total Return** | | | |
| **1 Year** | **35.2%** | **21.6%** | **20.8%** |
| **5 Years** | **20.4%** | **60.5%** | **36.8%** |
| **Since Inception** | **91.4%** | **148.4%** | **86.1%** |

But our companies have started seeing a more stable environment over the last few months. The "cost optimization" phase is almost finished, which is starting to bear fruit in the form of leaner

*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.*

business models (i.e., lower fixed costs), and thus improving margins as sales recover. As this period of downsizing comes to an end, the focus is shifting towards growth investments that will hopefully pay off over the next few years.

The macro environment is providing support as well, as the Fed's aggressive interest rate hikes are starting to take hold and inflation is softening. Over the last few weeks, the market has begun pricing in a scenario of these rate hikes being finished for this cycle, and rates to start coming down later next year.

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Notably, the positive performance this quarter was largely driven by our Chinese investments. Several of these companies are in fact now trading close to their multi-year highs.

If 2022 was a year characterized by indiscriminate selling in Chinese equities, 2023 is about *diversion*. Last year, broad-based selling pressure pushed individual stock prices towards valuations that priced in severely pessimistic scenarios (some deservedly so, and others not). This created a fertile environment for stock-picking.

This year, we're starting to see those companies with proven resilience in their business models diverging from the pack.

Companies such as Pinduoduo and New Oriental (both Hayden investments), or others like Miniso and Luckin (non-Hayden investments) are exhibiting extraordinary growth – in stark contrast to the country's worst economic environment in decades. Despite such an environment, these businesses are *profitably* growing between ~40% – 88% y/y (as of Q2 2023), and their stock prices are beginning to reflect this reality[3].

There's still a way to go though, as we're only two-thirds towards our estimate of fair value. But as our theses continue to play out for this segment of the portfolio, we'll be carefully reallocating the capital elsewhere. Sell-side estimates have been revised sharply higher since we first invested last year (albeit with still healthy skepticism from the market around these estimates). Therefore, our analytical differentiation versus the market isn't as large as it was a year ago.

Attempting to think ahead, I'm increasingly searching for opportunities where we could potentially deploy these proceeds, if our theses do play out as originally envisioned. For example, I've been spending more time scouring around beaten-down sectors like US small-caps, in recent months.

Hunting for such opportunities isn't a quick process though, as historically we've only found one or two new investments which meet our investment criteria. But it's something I'm increasingly preparing for, when hopefully our original theses become reality for these investments in a year or two. Partners should expect our cash balances to fluctuate more than usual during this period.

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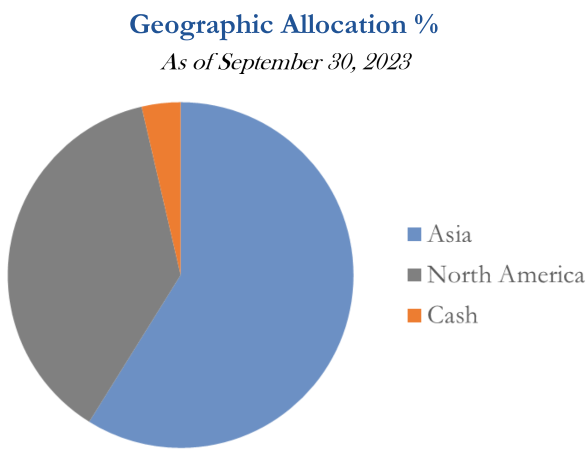
[3] As of November 7, 2023, PDD is up +78%, EDU is up +133%, MNSO is up +290%, and LKNCY is up +75% over the past year. The returns are even more significant versus their troughs.




Our portfolio gained +11.6% in the third quarter of 2023, versus declines of -3.3% for the S&P 500 and -3.7% for the MSCI World indices. This brings our annualized return since inception to +7.6%.

At the end of the third quarter of 2023, approximately ~59% of our assets were invested in Asia, ~38% in North America, and the remainder in cash.

## The Predictability Premium

There's a fascinating dynamic prevalent across almost any market around the world that we've looked at. It's the willingness for investors to dramatically over-pay (in my opinion) for highly stable / predictable cash flow streams, relative to other investments that might return just as much capital over a 5-10 year period, but have cash flow streams that are more volatile year-to-year.

The fact a premium exists makes sense. Humans are naturally risk adverse, and highly value stability. A stable cash flow stream makes it easier to plan budgets & count on that cash flow for other uses, offers greater peace of mind as an investment (not checking stock prices every second), and even offers the optionality to use leverage to enhance these returns even more.

But what is the "right" premium for such stability of returns? Is it a 200 – 400% premium as we've witnessed some of these securities trading at? Or should the logical premium be closer to +30% higher?

What the exact *magnitude* of this premium should be is harder to answer. It's dependent upon human nature and the mental benefit the investor gets from having peace of mind. But perhaps we can look at empirical evidence, to gauge this?

**Stable vs. Volatile Cash Flows**[4]

*Source: Illustrative example*

| Year | 1 | 2 | 3 | 4 | 5 | Cumulative CF | |
|---|---|---|---|---|---|---|---|
| Company A | $ 100 | $ 105 | $ 110 | $ 116 | $ 122 | $ 553 | <= Likely trades at 40x P/E |
| *memo: Growth Y/Y* | | *5.0%* | *5.0%* | *5.0%* | *5.0%* | | |
| Company B | $ 100 | $ 120 | $ 110 | $ 90 | $ 140 | $ 560 | <= Likely trades at 10x P/E |
| *memo: Growth Y/Y* | | *20.0%* | *(8.3)%* | *(18.2)%* | *55.6%* | | |

| | |
|---|---|
| NPV - Company A | $286.42 |
| NPV - Company B | $291.93 |
| *memo: Discount Rate* | *10.0%* |
| *memo: Initial Investment* | *$ (100)* |

For example, look at any market around the world, and consumer staples, real estate, and utilities companies will typically be among the most expensive stocks in that market.

One of my favorite examples is Nestle India (NSE: NESTLEIND), the Indian arm of the 150-year old Swiss food & beverage conglomerate. It's one of the best performing stocks in India up ~370x since 1990, having benefitted from India rising consumer class.

However nowadays, shares now trade at ~78x P/E ratio, and dropped to "only" ~30x P/E during the 2009 financial crisis (while the broader NSE market historically trades at ~20x P/E; LINK). Yet net income grew at just ~8% y/y over the last decade – certainly not exciting enough to justify such a valuation. So why do shares trade at such a ~4x premium, if it isn't able to grow profits at a significant difference to the country's GDP rate?

A ~78x P/E is equivalent to a ~1.3% earnings yield, despite the lackluster earnings growth, and in a world where 10-year US government bonds yield ~4.5%.

It's not just emerging markets either, where one could argue a "scarcity premium" given fewer quality public companies. Even in the US, Coca-Cola trades at ~30x P/E despite having the same earnings as 10 years ago. Proctor & Gamble is likewise at ~27x P/E, with earnings only ~12% higher than a decade ago (or a ~1% annual growth rate). This equates to a mere 3.3% - 3.7% earnings yield.

Both of these companies actually have *lower* revenues than 10 - 15 years ago too, indicating that their profit growth is mostly from margin expansion. This can only last for so long before there's no more excess expenses left to cut.

I find it ironic that all these companies trade as "bond-equivalents" in the minds of investors - even commanding lower yields than US treasuries, the safest security in the world. But it's clear that their businesses are not nearly as safe. Coca-Cola is facing disruption risk from consumers shifting to new, heathier beverage brands, and Proctor & Gamble is facing disruption from direct-to-consumer brands that offer their products for a fraction of the price (discussed in our Q3 2017 letter; LINK).

[4] Company A would likely command a much higher valuation multiple in the market, despite Company B generating more in cumulative cash flows. At the same discount rate, Company B would be worth more. But in reality, the market would likely ascribe a higher discount rate to Company B, given the earnings volatility being perceived as riskier, thereby depressing the valuation.

But these companies are ~35% more expensive than US Treasuries, despite the heightened risk. On a risk-adjusted basis, one could argue the implied premium is even higher.

Perhaps the explanation is simply the price volatility difference between these stocks and treasuries over the last two years. For example, 10-year Treasury bonds are down ~-20% since the beginning of 2022. By comparison, KO and PG are remarkably down only -4 - 6% over that time frame.

US Treasuries are supposed to be the most reliable assets in the world. But perhaps the lack of price stability the past few years, is what's driving such a large premium towards consumer staples stocks?

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This immense desire for stable returns is starting to trickle into the equity market structure too. For example, in 1985, there were only 17 market-neutral and event-driven hedge fund strategies, managing ~$107 Million dollars between them[5]. Compared to the mutual fund industry's $495 Billion, these shorter-term focused funds had very little impact on the market (~0.02% the size)[6].

Nowadays, market-neutral, event-driven, and multi-strategy funds comprise ~$973 Billion in total assets, or ~3.4% the size of mutual fund & ETF assets[7].

These strategies tend to focus on short-term "events" (company announcements, mergers, earnings, etc.) or seek to dynamically hedge out "beta" exposure. Their goal is to minimize exposure to the broader market's ups & downs, and offer a smooth stream of returns. The nature of these strategies require frequent trading, which ironically can create even more volatility, as everyone puts on the same trades around the same "events".

While these strategies remain relatively small compared to the overall market, they've still grown ~170x in the last four decades. These shorter-duration strategies also have an out-sized impact on markets and implies a much higher volume-based market share. As mentioned before, they tend to trade much more frequently than longer-duration strategies (and these stats don't even include algorithmic strategies).

The proliferation of such funds, combined with technology reducing trading friction, have contributed to investor time horizons shortening considerably over the last few decades. According to a recent study, the average holding period for US stocks has shortened from 5 years in the 1970's to only ~10 months in 2022.

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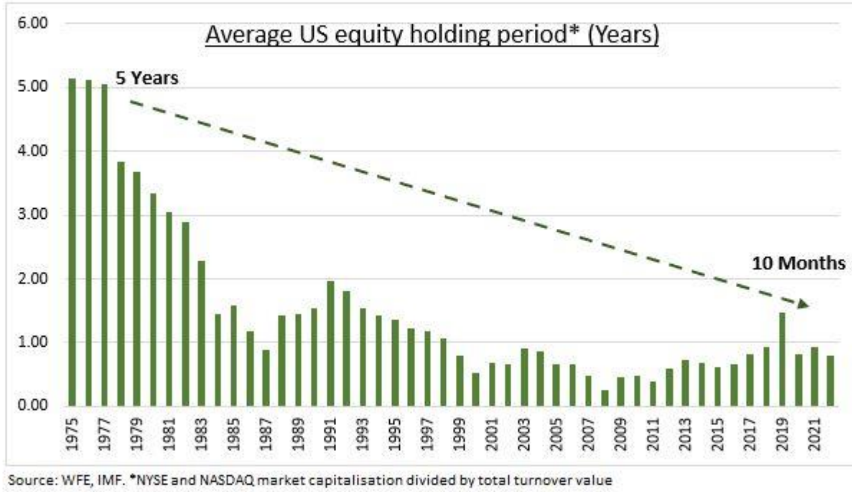
[5] Chadha, B., & Jansen, A. C. (1998). "III The Hedge Fund Industry: Structure, Size, and Performance". In Hedge Funds and Financial Market Dynamics. USA: International Monetary Fund (LINK).

[6] LA Times (LINK)

[7] As of Q4 2022. BarclayHedge (LINK). Mutual funds and ETFs have ~$22.1 Trillion and ~$6.4 Trillion in assets, respectively (LINK 1; LINK 2).

**US Equity Holding Periods**

*Source: eToro (LINK)*




It's clear that investors are increasingly attracted to these low-volatility / short-duration strategies. After all, the industry couldn't grow 170x, without having something resonate with customers.

So, what's the price of this stability? Well, such funds generally cost investors ~400% the average cost of a mutual fund, and ~1,200% the average ETF[8].

The most notorious multi-manager funds charge even more – billing clients "pass-through" fees (portfolio manager compensation, travel expenses, even gym memberships for their traders) – which can equate to another 10% or more of profits. This is on top of the standard management and performance fees. For example, Citadel was able to charge clients ~43% of the gross profits it generated last year ($12BN in fees vs. $28BN gross profits; LINK).

The underlying question should be, why are investors flocking towards these types of strategies in the first place? While there was certainly unexploited alpha in the early-days with little competition, why has this segment of the market continued to explode in the past decade – well-after the early advantages were exploited & the mechanisms behind such strategies well-known?

As investors flock to the sector and assets balloon, competition for returns will inevitably increase. Are these smooth returns sustainable, and really worth the multi-fold higher costs?

Perhaps there's something intrinsic to human nature too. There's more noise in the world versus several decades ago – rapidly developing technology, a diverging multi-polar world, constant news flow / media. Are these factors driving us as a society to place more value on predictability? In a volatile world, is the scarcity of "predictability" growing even more valuable?

It shows in the premium fees charged, that investors are more than willing than ever to pay large amounts of money to have someone else remove the noise. Rather than embracing this new world and finding a way to take advantage of the noise.

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[8] According to HFR, the average hedge fund fees are 1.35% management fees + 16% of performance (LINK). Average mutual fund fees are ~0.66% (LINK). At an 8% annual return, this is a ~4x difference. It grows even larger as returns increase.

We see this "predictability premium" even outside of the investing world too. For example, subscription services have proliferated over the last decade – impacting products such as software, gaming, groceries, entertainment, and even Taco Bell (LINK).

While this is all convenient (maybe, unnecessary?), there's a reason businesses of all types view these subscription models as the holy-grail.

For instance, Recurly found that 42% of consumers spend *more* with the company, when they're on a subscription plan (LINK). This is driven by the feeling of "exclusivity" and also an increased loyalty to the brand.

Consumers routinely "underestimate" (i.e., forget) how much they spend on these subscriptions per month. Those in a recent survey estimated they spend $86 per month, when the actual total was $219 (LINK). We end up spending more on a subscription (255% to be exact), for the simple privilege of not thinking about it.

Predictability allows us to turn our brains off. To not be on edge constantly, worried about what this quarter's earnings are going to do to a stock, or worried that we're going forget to buy pet food this month.

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I worry that all this has negative implications for society over time. That we're becoming too sensitive to short-term pain and uncertainty – willing to pay exorbitant prices to get remove it.

In the investing field, perhaps it's evidence that investors will continue to care more about a company's *volatility* of their earnings stream year-to-year, rather than the overall direction or magnitude.

This would mean that companies can remain at extreme valuations (both on the high and low-ends) for greater than in previous decades. The market's proverbial "weighing machine" wouldn't necessarily be broken, but it could take much longer to balance.

If this attraction towards predictability (and the ~300% pricing premiums associated with it) are just human nature, the next logical question should be – "how can we exploit this natural tendency as investors?" If we can't fight the trend, how can we use it to our advantage?

Perhaps the opportunity is finding situations where a company's earnings stream is in the middle of transitioning from a volatile earnings profile, to a more predicable one. The most well-known example of the last decade, is the transformation of software from buying boxes at the store every year, to monthly subscriptions automatically billed via your credit card. This not only made earnings more predictable, but it also drove up revenues as customers spent more per year on subscription than when they made one-time conscious purchases.

This transition to a recurring model drove software valuation multiples up ~150% over that time frame. Software companies were routinely valued < 10x EV / EBIT from 2010 – 2013. After an industry-wide shift to this new business model, software valuations are now routinely ~20 – 25x EV/EBIT.

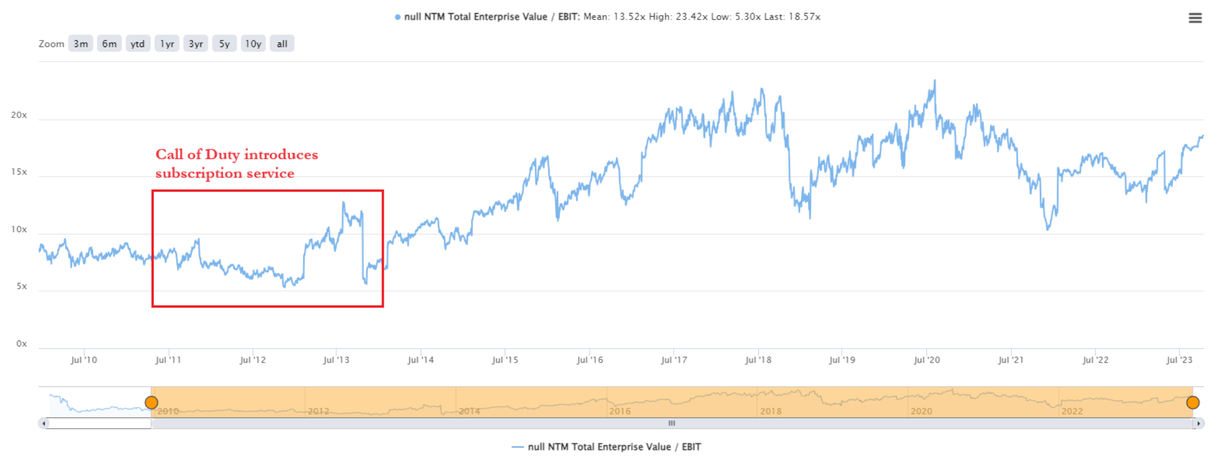
**Adobe's Valuation**

*Source: Tikr.com; EV/EBIT from 2010 - 2023*


The same thing happened within the video game industry too – going from one-time purchases, to monthly fees for online play & continual content updates, and micro transactions (which further increased how much players spend). Companies like Activision saw their valuations expand from ~8x EV / EBIT, to ~18x afterwards.

**Activision Blizzard's Valuation**

*Source: Tikr.com; EV/EBIT from 2010 - 2023*




Even Berkshire Hathaway's most famous investment of the last decade – Apple – was based on a similar set up. When Berkshire invested in 2016, Apple's subscription revenues were just starting to cross ~10% of total revenues. Today, that figure is ~25%.

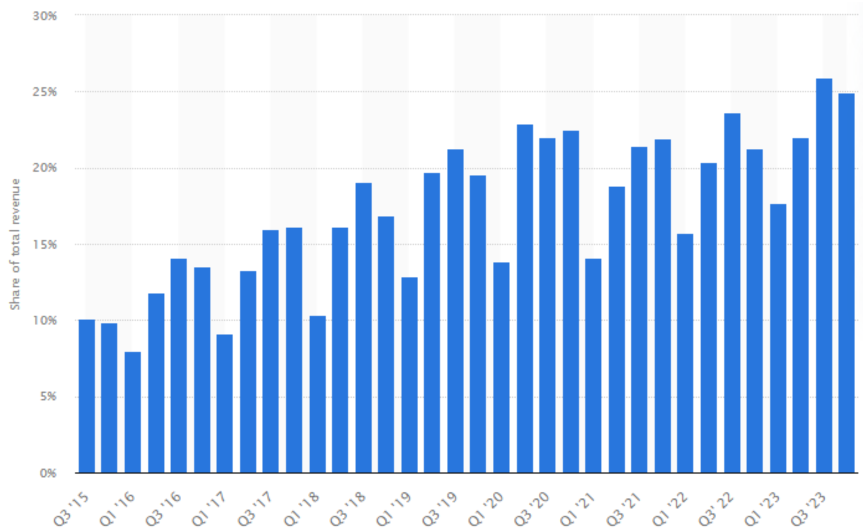
While operating income has grown +90% from 2016 to 2023, the valuation multiple itself has expanded by ~300%, from ~6x EV/EBIT to ~24x EV/EBIT today.

Investors have evolved their perception of Apple's products – from that of a "fad" hardware company at risk of competition, to that of a "consumer staple", a necessary part of a household's budget.

As such, the vast majority (~85%) of Apple's 7x stock return over the past eight years is due to successfully changing investor's *perception* around the earnings stream being more predictable, rather than *creating value* through earning growth.

## Apple's Services Revenues, as % of Total Revenues

*Source: Statista (LINK)*




## Apple's Valuation

*Source: Tikr.com; EV/EBIT from 2016 - 2023*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Perhaps another way to take advantage is where a company's earnings profile becomes less volatile over time, due to natural maturation.

Younger companies have higher earnings variability, by nature. The business is prone to greater competition, needs to spend a greater portion of revenues on R&D and marketing (thus profits are volatile, based on that quarter's budget), and not having the same level of loyalty from their customers yet (thus making their unit sales more volatile).

But as a business matures, these issues naturally solve themselves. For example, with consumer marketplaces, the profit potential is typically a function of relative market share. The greater the gap in market share between itself and the next largest competitor, the easier it is to pass on pricing increases. At the same time, consumers have few other options to turn to, thus making the earnings stream more recurring.

Or in the case of software, customer churn should naturally decrease over time. Those customers who are not a good fit will eventually quit the service, while those who are will build familiarity & work-flows with the product, making it ever-harder to switch as time passes. Over the years, retaining existing customers becomes a much larger driver of the business vs. acquiring new customers. All of this naturally increases the predictability of the company, and thus justifies an expanding valuation over time.

The key might be to find companies where earnings will inevitably become more stable over time, as long as the business continues to grow. In these cases, earnings predictability is a natural "output" of the business succeeding (unlike say, an oil services company, which is still at the whims of the commodity price regardless of how dominant it becomes).

Perhaps the opportunity is in finding such companies early-on, right as they're on the cusp of making that earnings profile transition.

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Studies have historically shown that the "loss aversion coefficient" is typically 2 - 2.5x in individuals (LINK). This means that given a possible -$100 loss, the potential reward needs to be at least +$200 - $250 to offset the potential pain from losing the bet. But as the world becomes more sensitive to volatility and uncertainty, will this premium grow even larger over time?

Whatever the case, it's clear that there's a distinct & large premium for "predictability" / stable returns in today's world. We should embrace this as a "universal truth," and use it to our advantage.

## PORTFOLIO REVIEW

**SmartRent (SMRT):** A few months ago, I drove down to Scottsdale, Arizona to meet with the SmartRent team (see our original investment memo here; LINK). Lucas (CEO), Hiroshi (CFO) and Brian (IR), were generous enough to spend a few hours with me, and I left even more confident that the business is on the cusp of producing significant free cash flow in just a few months[9].

It was coincidental timing as well, since a new short report targeting the company had just come out a few days earlier.

Short reports on our companies are not new to us. During our ownership, nearly every single investment has been subject to a short-seller report at some point. Most of our companies are still developing, and therefore have a higher likelihood of the market misunderstanding their business models. But I actually think this aspect is a benefit (even if annoying at the time), since

[9] SmartRent is our last core position, which has yet to prove their ability to generate cash flow.

it overtly allows us to understand what controversies or concerns the company needs to overcome, for the stock to appreciate.

In SmartRent's case, I had a cordial call with the short report's author prior to meeting with management. I think the primary concerns revolve around whether they can keep growing the number of units they deployed per quarter, and how much of their existing base is from RET Ventures (their original seed investor) promoting the service to their own LPs[10]. The crux of both of these concerns is the same – that the company won't be able to scale to a large enough customer base, to cover their costs and reach profitability.

I suspect what these short proponents are missing, is that the slowing unit growth is a *conscious* strategic decision, rather than a negative byproduct of the product's limited appeal. For example, Lucas told me earlier this year, that they restructured the sales & account management KPIs, to give greater emphasis on increasing existing customer lifetime values (getting them to buy add-on products, raising software ARPUs, etc.), instead of unit growth. This is underpinned by management's laser-focus on getting profitable, as quickly as possible.

For example, sales & marketing per new booked unit have increased from $64/unit in 2021, to $74/unit in 2022, to an estimated ~$93/unit this year. Obviously, the cost of acquiring new units is increasing.

It's a natural fact of the business maturing – SmartRent already counts 15 of the top 20 real estate owners as customers. Each of these customers own ~70,000 units on average. Meanwhile SmartRent has another 573 customers, who own ~5.9M units between them. This equates to an average ~10,000 units each[11]. By definition for SmartRent to grow from here, they'll have to penetrate further into this "long-tail" of US real estate owners.

The problem is whether selling to a 70K unit owner or a 10K unit owner, the marketing costs are the same. A sales representative needs to devote ~6 months – 2 years of their efforts, launch pilot deployments, multiple meetings, etc. before the owner is usually comfortable signing on for this new product. But this cost is amortized across fewer units for incremental "long-tail" customers.

Note, the return on this customer acquisition cost is still highly positive, with SmartRent generally earning back their cost < 1 year after the contract's signed. But it's still more expensive than what it was a few years ago. The low-hanging fruit has already been picked.

The other issue is that "long-tail" owners generally take longer to sign on. In the US, the majority of these smaller owners are still family-run businesses and tend to resist change. Unlike the large institutional owners who are public companies / REITs and professionally managed, the smaller owners have multiple conflicts that make them a tougher sell.

For example, they tend to care about the upfront capital cost a lot more (given lower access to cheap funding vs. institutional owners), even if the project ROIs are highly attractive. They're hesitant to take a large chunk of cash out of their own pocket, to make this capital investment.

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[10] If partners refer back to our original SmartRent investment memo (LINK), RET Venture's own investors are 40 of the largest multifamily REITs and real estate owners in the US, with 2.4M collective units.

[11] This is just a simple average. Obviously, some customers will be much larger, and some much smaller than this.

Or they simply don't want to change what's worked so far, and therefore will be resistant to adopting new technology, until they're forced to by competition.

This is why it was smart for SmartRent to partner with RET Ventures too. In my opinion, having RET Ventures push the product to their owns LPs, who are among the largest real estate owners in the US, was arguably what allowed SmartRent to corner this market in the first place.

It got SmartRent to critical mass – it's the customer relationships and a reliable brand that give them an advantage in this business. The software itself is relatively commoditized, as there are several startups that have a similar product.

But the reason why SmartRent has more units deployed than all the competition combined, is that new customers prefer to go with the solution that the industry thought leaders are using. Just as the old maxim is "nobody ever got fired for buying IBM," in this vertical it's "nobody ever got fired for buying SmartRent".

In return for originally giving RET Ventures LPs a discount, SmartRent got the best marketing they could ask for, in return. Companies like UDR and MAA are the industry thought leaders and have been promoting SmartRent's product at conferences, touting the high returns they're getting by deploying the product on earnings calls, talking about the staff efficiencies achieved, and generally crediting the product for improved profitability. The RET Ventures cross-promotion is *a feature, not a bug*, of this relationship.

The shorts point to RET Ventures exiting SmartRent stock as a sign that these customer relationships are at risk. But the fact is that the shares weren't sold, but rather distributed to their LPs in-kind. RET's venture fund was simply coming up towards the end of its life. These distributions have been going on since two years ago, and just finished in February (LINK). These LPs are the same customers of SmartRent, and are now direct shareholders.

Second, I posed this question to Lucas when we met, and he responded that none of RET's LPs have cancelled, or even shown any indication of wanting to leave. In fact, they continue to sign up new units for deployment.

Having said all this, the goal of the company is to get to profitability as quickly as possible. And given the rising cost of acquiring new units, it's much easier to achieve this via pricing increases instead. ARPU growth is a far more important lever, than unit growth for this reason.

Software ARPU has doubled in the last two years – from $2.76 in 2021 to $5.41 this past quarter. This contributed to a +48% operating margin improvement over that time period.

What gets us excited though, is the rates that new contracts are being signed at. SmartRent just reported that new booked units are priced at $9.04 per month, or +67% above the average rates today. These new booked units will be deployed over the next couple of years, while existing contracts will also renew at higher rates and continue to add-on new products. This should bring average ARPU closer to the new rates over time.

The company is also becoming more asset-light, by working with ADI Global as their primary distributor (LINK). This is set to free up at least ~$20M of capital for SmartRent, while putting the new customer sales function on ADI, which has a broader marketing reach with smaller real estate owners.

Since courting and servicing the long-tail customers has a lower return than the large early adopters, it makes sense for SmartRent to partner with a distributor that has the scale & willingness to do so. In addition, SmartRent also started allowing smaller owners to "self-install" the product in their units, thereby saving on installation & labor costs.

These changes are already having an impact. Just last quarter, the company was able to free up ~$21M in working capital[12]. Additionally, SmartRent stated that this benefit does not take into the ADI deal, but rather only from improvements in their internal demand forecasting. These changes are significant for a company that has an enterprise value of just ~$380M.

A few weeks ago, the company officially confirmed that they'll be EBITDA positive in the fourth quarter, and plans to generate free cash flow early next year (LINK).

All considered, it looks like SmartRent is on track to generate ~$35M in free cash flow next year, and over $50M in 2025. At those rates, the company would produce ~9% - 13% FCF yields, while growing software revenue at above 25% CAGRs in the medium term, with 0% historical customer churn.

In fact, I wouldn't be surprised if the company starts returning a portion of its sizable $210M cash balance (36% of its market value) to shareholders in the near term. When I asked Lucas about potential share buybacks recently, he seemed very excited about the idea.

As the company gets closer to being free cash flow positive, there will be less and less incentive to keep such a large cash buffer on the balance sheet. It's possible that shareholders will see a portion of their investment returned sooner than expected.

## CONCLUSION

Over a year ago, I started heavily increasing our allocation to companies based in China. Starting from just ~10% of the portfolio in early 2022, we would eventually end the year at over 40%. This was the highest allocation we've ever had to China in our firm's history.

These decisions weren't a bet on the Chinese macro-economic environment. Rather, we were simply able to acquire stakes companies & partner with entrepreneurs that we've greatly admired for years – all at distressed prices[13].

Such best-of-breed companies were trading either below the net cash on their balance sheet (and had already indicated they'd start generating free cash flow shortly), or at low-single digit FCF

[12] Q3 2023. Across inventory, prepaid expenses, and accounts payable.

[13] For example, I first wrote about Pinduoduo in Q2 2018, and New Oriental / China's crack-down on for-profit education in Q2 2021.

multiples based on what'd they were set to earn a couple years out[14]. And even in the worst geo-political scenario, I believed we had avenues to get our capital back.

I mention this, as I suspect that tides are changing for the better. I just returned from a trip to Europe and the Middle East last month, and had a chance to meet with other investors in the region. Our conversations would inevitably gravitate towards our Chinese investments, since I've written extensively on the topic this year.

I couldn't help but notice that the tone of such conversations was markedly different than a year ago. Last year, such conversations generally had an underlying tone of "How can you possibly be comfortable investing there?" This time around, the underlying tone was "Where are the best opportunities? Should we own Alibaba or Pinduoduo?" Political tensions are warming, and the domestic economy has stabilized. It seems that global investors are becoming more comfortable with the region as a result.

*"Capital earns the greatest rewards when available capital providers are most scarce."*

Our investments in the region have performed well, but I suspect the "easy returns", when there was a lack of interest and capital in the region, have already been made. As mentioned at the beginning, valuations are getting closer to our ultimate price targets. If investor interest continues, I suspect these will be realized over the next year or so.

As such, we're currently in an intense period of actively searching for new opportunities. Partners should expect our portfolio's cash balances to fluctuate in the meantime, and possibly seeing a few new names in the portfolio over the coming quarters, if we're lucky.

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We're also actively looking for interns in the coming semester, to help "turn over rocks". I've had the pleasure of working with Sherry Hu at NYU this semester, who is currently deep-diving into an online recruitment firm. As we seek to increase the velocity of new ideas, I'm hoping to have the opportunity to work alongside more exceptional students this Spring.

I've traditionally recruited from NYU (where I'm on the board of their IAG investment club) and also Columbia University's Value Investing program. Both are great training grounds for aspiring investors. But in a post-Covid age of remote work, we're open to exceptional students from other schools as well.

I can't promise that I'll have a chance to respond to every inquiry, but I do promise that I'll personally look at every application sent our way. Those interested should email me directly, and please include an investment memo that showcases your research process and investment philosophy.

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[14] I've laid out our theses in our prior letters, so please refer to those for more details.

Thank you to all of our partners, friends, and fellow investors whom I've met this year. I've visited nine different countries in the past six months and have had the pleasure of learning from every one of those conversations.

We've meet at the most diverse of places – from five-star hotels, to road-side cafes on plastic stools. From beachside coffee shops in Dubai, to hole-in-the-wall restaurants in the middle of a Manila monsoon (LINK). Thank you for teaching a foreigner your local experiences, and helping us both to understand the world a bit better.

Especially, thank you to our partners around the world. I've truly learned a lot from our conversations, and love the fact that Hayden is a collaborative effort from everyone involved. For those partners whom I haven't had a chance to catch up with recently, please reach out and let's arrange a time in the coming months.

I hope everyone has a joyous holiday season and thank you for being a part of the Hayden journey.

Sincerely,

Fred Liu, CFA
Managing Partner
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