Tapasya

Creating Generational Wealth

FEBRUARY 17, 2023

TAPASYA INVESTMENT FUND I

GLOBAL INVESTMENT REVIEW - III

INTRODUCTION

Welcome to the **3rd edition** of the "**Global Investment Review**".

As mentioned in the previous letters, the intent of this document is to detail the thesis of the companies the fund has made investments in. Besides articulating the thesis of the investment, it would also help to look back at the assumptions made to understand which ones were true and the ones that did not work out. It would help me become a better investor and help overall returns for the fund. It's a practice I have been following before starting this fund.

So far the past 2 editions have focussed on investments in the US and Europe. This time around we will focus on investments in China.

As you may have read in the annual letter I talked about the portfolio composition and sizing I used the analogy of soccer to describe the portfolio broken up into Defenders, Mid-Field and Offense. Keeping with this concept, this edition will contain 2 MidFielders. Just as a quick reminder, mid-fielders in our portfolio are basically long-term compounders. Defense is where I expect those companies to guard the portfolio from significant declines during drawdowns like 2022 and Offense are ones that I expect to have outsized returns and take on higher risk.

Between the time of thinking about the content of this document, writing it and publishing it; China moved from a zero-covid policy to a quick reopening to what I am expecting to be a start of a multi-year bull run in Chinese equities.

We have 2 investments in China, Alibaba and Tencent which also happen to be amongst the largest companies in China. We have acquired our position in Tencent indirectly through the purchase of PROSUS (PRX.AS) in the Amsterdam stock exchange which has a ~27% stake in Tencent.

SHOULD WE BE CONCERNED ABOUT CHINA

Though I am not a macro investor i.e. investing based on broader trends like stock market predictions, interest rate moves , etc. I never want to undermine the importance of the impacts of macro conditions. We have all seen this in 2022, which has been a painful year for most investors or those who watch their 401k's or IRAs closely.

The issue I have with macro investing is not because I feel it's unimportant but more since its unknowable. Predicting macro and having conviction to invest is like predicting the outcome of a chess game that is being played by 6 players simultaneously.

Then why am I writing this section here you may ask? The reason is primarily due to a lot of media attention and dialogue on China within the US (and "may be" vice versa). I write "*may be*" since I am subscribed to some Chinese newspapers as well, and see a lot less anti-American dialogue as much as I see Anti-China dialogue in the US media.

In any-case, I wanted to address this situation. These are the 2 most powerful countries in the world and I think it's in the best interest of each of the countries and the world that both work amicably. Also with China being the largest trading partner of the US I do not expect an all-out conflict. Should that happen and I am proven wrong, where each of us are invested would not really matter at that time?

Enough on geo-politics and macro, let's move on to information you may be more concerned with, which is the invested companies and the reasons.

ALIBABA (BABA)

Alibaba Group was established in 1999 by 18 people led by Jack Ma, a former English teacher from Hangzhou, China. Through its subsidiaries, it provides online and mobile commerce businesses in China and internationally. It operates through four segments: Core Commerce, Cloud Computing, Digital Media and Entertainment, and Innovation Initiatives and Others

Let's start with some financial history.

Income Statement | TIKR.com	3/31/16	3/31/17	3/31/18	3/31/19	3/31/20	3/31/21	3/31/22	LTM
Revenues	101,143.00	158,273.00	250,266.00	376,844.00	509,711.00	717,289.00	853,062.00	859,363.00
Total Revenues	**101,143.00**	**158,273.00**	**250,266.00**	**376,844.00**	**509,711.00**	**717,289.00**	**853,062.00**	**859,363.00**
% Change YoY	*32.7%*	*56.5%*	*58.1%*	*50.6%*	*35.3%*	*40.7%*	*18.9%*	
Cost of Goods Sold	(34,355.00)	(58,626.00)	(106,243.00)	(204,086.00)	(279,713.00)	(419,517.00)	(538,705.00)	(545,725.00)
Gross Profit	**66,788.00**	**99,647.00**	**144,023.00**	**172,758.00**	**229,998.00**	**297,772.00**	**314,357.00**	**313,638.00**
% Change YoY	*27.5%*	*49.2%*	*44.5%*	*20.0%*	*33.1%*	*29.5%*	*5.6%*	
% Gross Margins	*66.0%*	*63.0%*	*57.5%*	*45.8%*	*45.1%*	*41.5%*	*36.9%*	*36.5%*

BABA has had a very healthy revenue growth from 101 Bn RMB to 859 Bn RMB in 7 years. During this high growth period, its gross margin has declined but stays at a relatively healthy 36.5%. BABA has a very healthy balance sheet, especially looking at its cash reserves. Basically reminds me of a quote from Peter Lynch a famous investor 'Its very hard for a company to go bankrupt with no debt'.

Given BABA's balance sheet, it can withstand some significant stress in the economy. We want to be invested in such companies especially if the position sizing is large.

Free Cash Flow (FCF) is another metric that is very key to me. They have almost doubled their FCF in the past 7 years and I expect that to continue to grow at a steady pace.

Cash Flow Statement | TIKR.com	3/31/16	3/31/17	3/31/18	3/31/19	3/31/20	3/31/21	3/31/22	LTM
Cash from Operations	**56,836.00**	**82,854.00**	**125,805.00**	**150,975.00**	**180,607.00**	**231,786.00**	**142,759.00**	**154,307.00**
Free Cash Flow	**45,991.00**	**71,848.00**	**106,177.00**	**115,493.00**	**148,057.00**	**190,336.00**	**89,450.00**	**100,998.00**
% Change YoY	*37.2%*	*56.2%*	*47.8%*	*8.8%*	*28.2%*	*28.6%*	*(53.0%)*	
% Free Cash Flow Margins	*45.5%*	*45.4%*	*42.4%*	*30.6%*	*29.0%*	*26.5%*	*10.5%*	*11.8%*

The investor of today does not profit from yesterday's growth. The question hence arises - How confident we are about its future AND did we overpay for this stock?

Let me answer the over-pay question. This could be a little subjective at times but I will do my best to explain how I look at it.

Are we buying the stock at a good price?

I am sure you would have all heard about "**Margin of Safety**" and I use this term as well (don't expect anything original from me, I just learn from others).

"Margin of Safety" as Buffett has defined is buying the company at a lower price than its intrinsic value. The higher the discount OR lower the price relative to intrinsic value, the higher the margin of safety.

The question then arises is what is 'Intrinsic value' of the company. It was easier to describe this in the earlier days where companies had a lot of physical assets, with the advent of software this has gotten harder.

Intrinsic Value can be defined as the amount/$'s one should pay today for a company (or stock) is based on the future cash flows the company is going to produce from now to Judgment Day.

As I write this, I am sure I have lost some of you hence in the annual meeting I will talk more about this and you will get an opportunity to ask questions.

For now to simplify, I will tell you what I do. Below is one of the 2 techniques I use. This method is used for cash flow generating companies only. I calculate **Free Cash Flow Yield**, the calculation being FCF/Market-cap.

I expect the FCF yield to be higher than a typical 10 year treasury. At this time its about 4%. What that means is my risk free return for the long term is 4% pretty much guaranteed by the US government.

To make higher returns I need to take on additional risk. Equities by their nature are higher risk especially when you compare to a T-bill. Given that the best way to minimize this risk whilst buying equities is to buy a quality company 'cheap'. Cheap is defined in my books as FCF Yield. It is not determined by the stock price or it's associated fall. In the case of BABA the FCF Yield was 7% at the time of writing this, since then the stock has moved up over 30%+. This alongside the fact that as a country China is expected to have a reasonably high GDP growth in the foreseeable future.

Now that we have laid to rest whether we bought the company at a great price, let's look at the business itself and also understand the potential risks we are dealing with.

How does BABA make money

There are just too many businesses they run and hence will just use a chart to help explain some of this. Hopefully I don't get tagged as lazy for not typing all of it down.

If we look at the revenue distribution about 75% of revenues come from "Core Commerce". Most of this comes from China (67%) which showed a slow down in 2022, the rest (8%) comes from International. Consumer and Logistic services contribute 12% and Digital Media about 4%.

COMMERCE: Given Commerce is its biggest revenue driver, this is closely tied to consumer sentiment, besides growth in the economy and execution by BABA. Also retail is a very competitive business. With its push into grocery and offline business along with China re-opening, I expect Alibaba to resume its revenue growth. The one thing to be watched here is loss in market share. I expect declines in market share given the very high share the company has. That said significant declines here may be red flags that need to be watched.

CLOUD: China is in its nascency as far as Cloud business is concerned, with significant growth expected in the market. Given its strong leadership position and relatively shielded from Global competitors like Amazon, Microsoft and Google. This business has a lot of room to grow and should be the next big revenue driver for Alibaba.

PROSUS (PRX.AS)

Let me start with the caveat that this purchase is more complex than my typical leaning towards simplicity. It just happens to be a mis-priced opportunity I did not want us to miss. So far for the fund it seems like it is working determined as the current price being greater than purchase price.

Prosus engages in the e-commerce and internet businesses. It operates internet platforms, such as classifieds, payments and fintech, food delivery, travel, education, health, social, and other internet platforms.

The intent to buy Prosus was primarily to buy into TENCENT. Hence the focus of this document would be around Tencent

First, let me explain the reasoning behind this convoluted trade. Prosus holds 27.3% of Tencent besides many other companies in the online classified, food delivery and fintech companies across the globe.

As of Feb 14th, 2023 the market cap of Prosus was $103Bn while the Tencent stake it holds is valued at $124Bn. Just based on this fact, it's cheaper to buy Tencent by buying Prosus. Along with that, we get a lot more. There are a bunch of publicly listed assets (Meituan, Delivery Hero etc.) that total $134Bn. There are a bunch of unlisted assets valued at about $25Bn. If I assume '0' value for all unlisted assets, which ideally should hold some value; we still arrive at almost a 35% discount to the underlying value of the asset.

Furthermore, the intent as mentioned is to buy Tencent which is a growth story in itself. Hence the way I look at it, buy Tencent at a discount and get a large number of assets for free with potentially some of them being winners over the long term. If they are not, they should not hurt us.

Most of these other businesses, though showing high growth in revenues, are not cash flow positive at this time. This is expected to happen in 2024, providing a further unlock.

The management at Prosus is incentivized to bridge this valuation gap. To execute this they have started a series of buybacks. Coupled with these buybacks, Tencent is also pursuing buybacks due to the low valuations.

With all that said, basically its a great business (Tencent) available at a large discount to the market price and I expect this to be a multi-bagger over the next few years.

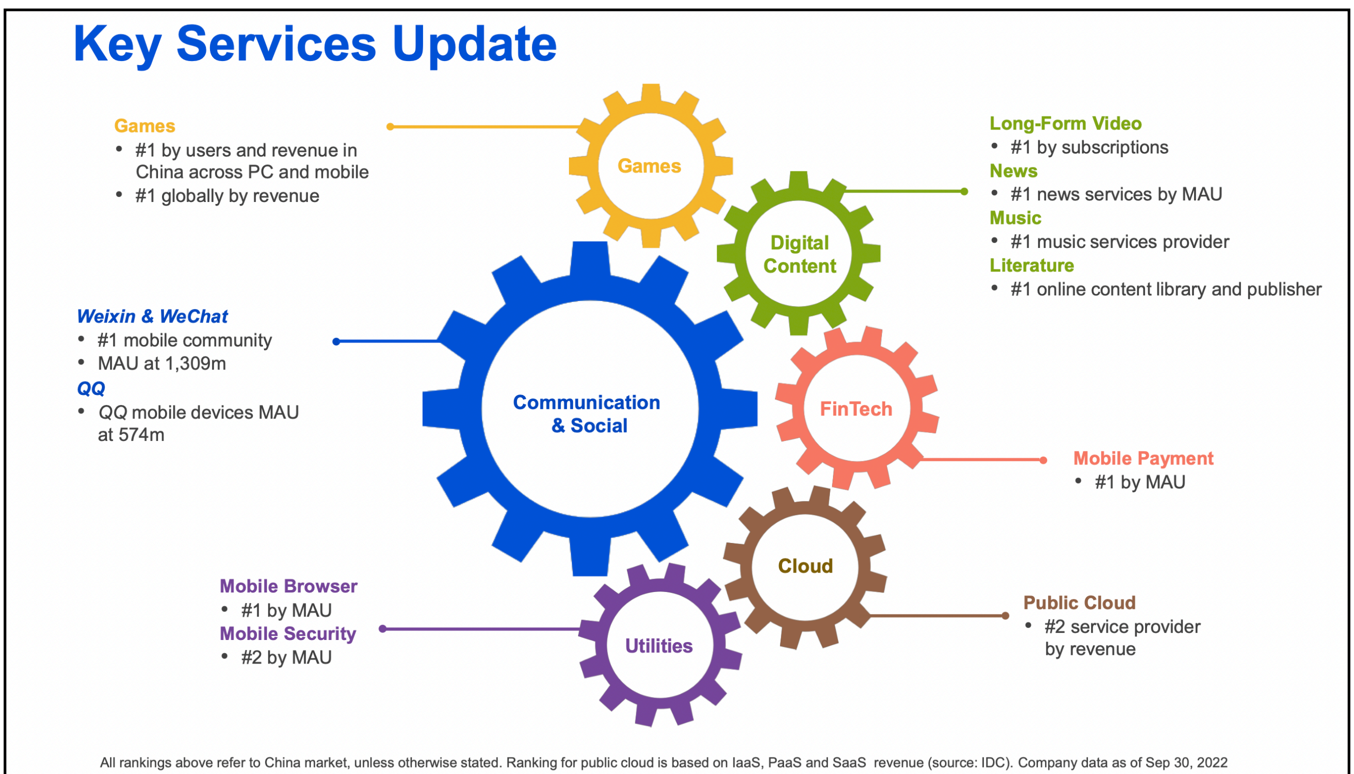
Financial history - Tencent

Income Statement | TIKR.com	12/31/16	12/31/17	12/31/18	12/31/19	12/31/20	12/31/21	LTM
Revenues	134,780.00	194,422.00	307,863.00	369,723.00	474,569.00	552,433.00	546,426.00
Other Revenues	17,158.00	43,338.00	4,831.00	7,566.00	7,495.00	7,685.00	7,360.00
Total Revenues	**151,938.00**	**237,760.00**	**312,694.00**	**377,289.00**	**482,064.00**	**560,118.00**	**553,786.00**
% Change YoY	***47.7%***	***56.5%***	***31.5%***	***20.7%***	***27.8%***	***16.2%***	
Cost of Goods Sold	(67,439.00)	(120,835.00)	(170,574.00)	(209,705.00)	(260,440.00)	(314,187.00)	(319,058.00)
Gross Profit	**84,499.00**	**116,925.00**	**142,120.00**	**167,584.00**	**221,624.00**	**245,931.00**	**234,728.00**
% Change YoY	***38.0%***	***38.4%***	***21.5%***	***17.9%***	***32.2%***	***11.0%***	
% Gross Margins	***55.6%***	***49.2%***	***45.5%***	***44.4%***	***46.0%***	***43.9%***	***42.4%***

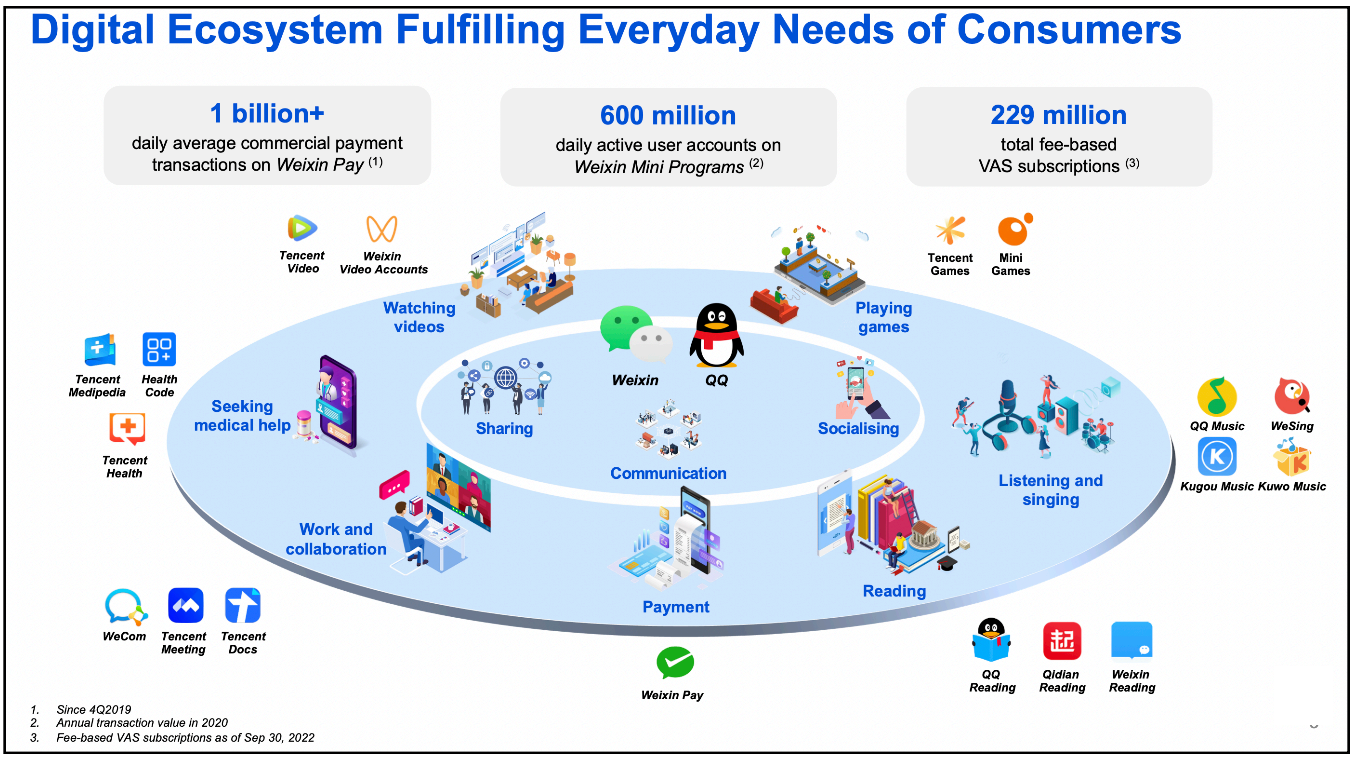
** Numbers above in RMB

As you see here, very significant growth in revenues over the years. 2022 was an odd year for China with lockdowns etc; where Tencent saw marginal declines in revenue. Its gross margin is at a healthy 40%+. The balance sheet is very strong and can withstand some severe macroeconomic shocks.

Let's take a look at its business and why in my view this has the potential to be the largest company by market cap in the world.

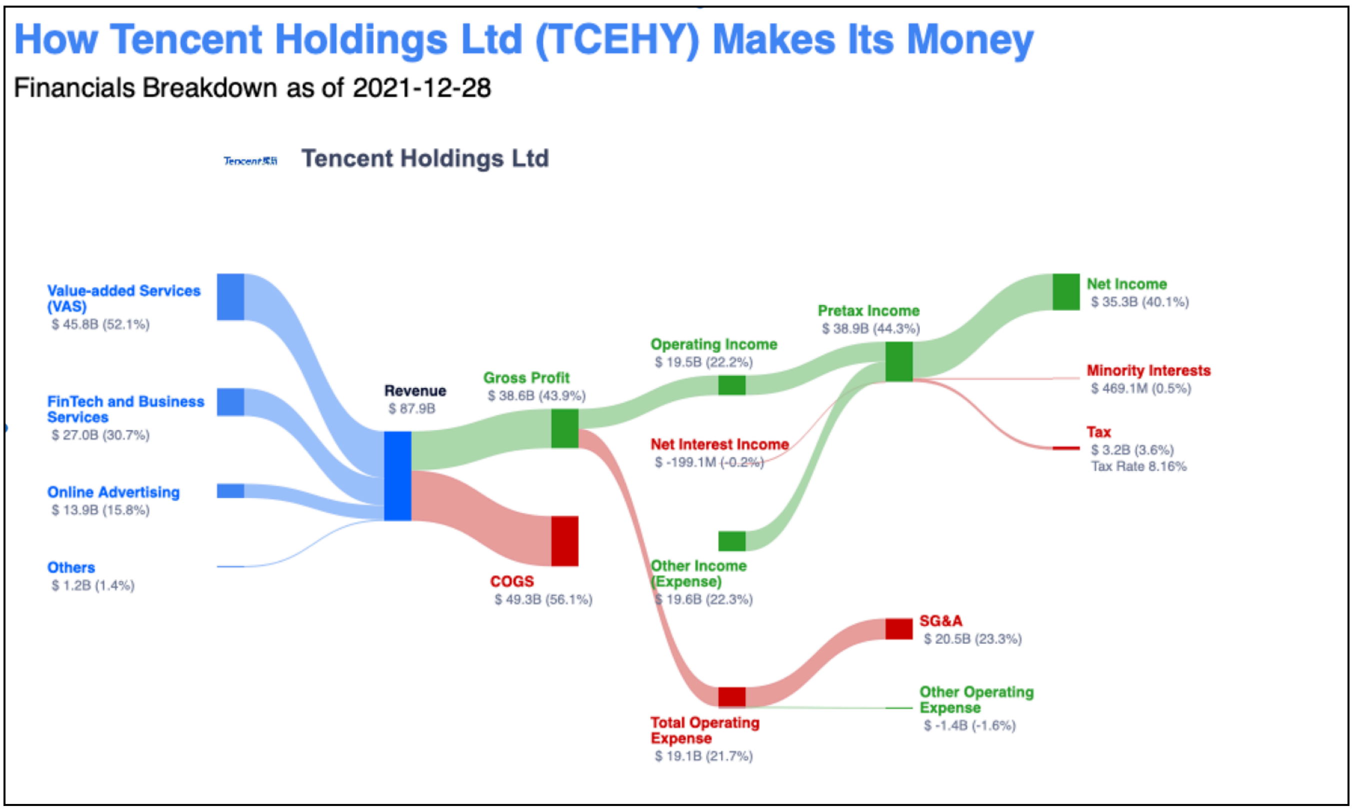


For the typical US investor/individual the power of a Super App like WeChat/ Weixin may be hard to relate to given the App has within it, financial services, video services, social media, gaming , etc., all embedded into a single interface. Below, the company has made a good attempt to explain this ecosystem and how large this is.



Along with the strength of being the #1 Gaming company in the world, social networks (Value added services - VAS), Online Advertising, Fintech and Business Services that have driven a 24% CAGR growth in the 5 years until 2021, one of the overlooked aspects is its investment portfolio. The portfolio has about 75 listed companies and 48 unlisted. These itself equate to $125B USD.

Source: gurufocus.com



Risks Investing in China (Alibaba and Tencent)

The risks have been consolidated for Alibaba and Tencent since, many of them are broader in nature. Company specific risks have been called out as such.

1) **The China risk** i.e. geo-political risk. I have covered this in the section right upfront (page #2) hence won't spend more time here.

2) **VIE (Variable Interest Entity)** structure in simpler terms the owner of the ADR/ADS does not actually own the shares. A VIE structure is basically where the investor has controlling interest but not voting rights. The risk here is its not enforceable by law in China.

   My view - The total Chinese market cap is about $11 Trillion, About $1 Trillion is listed in the US. Harming the investors of the largest Chinese companies in the world would send a very wrong message to the world and investors and will truly make China Un-investable should that happen. Should there be other geo-political issues that cause damage, I have represented my views in Page #2

3) **Delisting**: the Chinese ADRs were threatened to be delisted should they not comply with PCOAB - basically US Audits. These thus far since December' 2022 seem to be moving in the positive direction. I don't expect this to be an issue.

4) **Competition**: China is a highly competitive market especially in Retail which is BABA's key revenue driver. This would have to be closely watched like I would for any other companies we are invested in.

CONCLUSION

I expect both these companies to be long-term compounders and multi-baggers. I strongly believe we are buying them cheap, much below what they are worth over time. The Chinese market and specifically these companies have witnessed significant decline in their market caps in recent years (2021/2022).

Though that is never the reason to buy, as one can argue the earlier high prices were not right to begin with. Hence I look at cash flows, FCF yield , etc., to make sure we are not overpaying.

All investments are made with a multi-year horizon. I prefer to give each company at least 2 years from purchase date approx. to understand whether the thesis is being realized or not. Will give the same time to these investments unless there is a significant change in the underlying businesses or change to the theses.

Markets are volatile and investment decisions many times are emotion driven. As an example, both these stocks which have now gained over 20%+ since purchase, were down about the same in Oct 2022. Due to the conviction in the thesis I was able to buy some more at lower prices.

I would welcome any feedback you may have on this document and as always feel free to reach out to me by email or phone if you have any questions.

We are in this journey together, our biggest advantage is going to be our collective focus on the long term along with my skills on capital allocation.

If you have managed to read this document in its entirety itself is one measure of success for me, as unless I receive feedback I will assume it was a reasonably good read.

In my next Global Investment Review, I will focus a couple of our investments in the USA.

APPENDIX

In regard to the investment thesis document, I want to mention some references that I have used for ideas on writing this document.

Firstly, Nick Sleep and Qais Zakaria (Nomad Investment Partnership), used to provide such documentation to their investors. You would see a common thread across my investment philosophy and how I manage the fund, similar to Nomad's which closed in early 2014 (thankfully, else they would be the best game in town - I would still compete though!!).

Others that I have referenced are based on what I have read over the years which includes Warren Buffet's Annual Shareholder Letters, Nick's thesis on Costco and also Guy Spier's communication to his investors. All of this information is in the public domain.

Thank you for taking the time to read this and as always, if there are any questions please do not hesitate to reach out to me.

Sincerely,

Pratik Kodial