Tao Value Q3 2017 Letter

October 18th, 2017

Dear partners,

For the quarter ended September 30, 2017, Tao Value recorded a return of +5.83%. This compares to a gain of +5.08% of MSCI All Country World Index (ACWI). It should be noted that there was only one position contributed over +100 bps to the overall performance. That means the return could also be interpreted as the mercy of Mr. Market, as the rewards may not be specific for insights/views on specific holdings.

Market this quarter continued its steady march to reach yet another historical high across the globe. On the other hand, we've seen Seth Klarman, a legendary value investor known for his uncompromising disciplines, decided to return capital to investors. A widely accepted (including Warren Buffett) justification of such levered market wide valuation is that one must take into consideration of unprecedented low treasury yield. If 10 years treasury only yields 2%, a 25 P/E market (i.e. 4% earning yield) may as well be fairly priced. I do not disagree with this argument. However, as we care about future returns, the real question is whether the low rate will sustain, and if/when it changes how other assets prices would change with it. A natural inference based on mean reversion is that <u>prospective return in the rest of this cycle will possibly be low</u>, considering elevated asset pricing, abundancy of cheap capital and compressed credit spread. However, we are not going to try to guess catalysts for such a reversal, or to time it. Instead we prepare for it when looking at potential capital deployment opportunities.

There is however a wild card in play – new technologies. Blossomed disruptive technologies probably haven't got identified so frequently for decades, to name a few, Cryptocurrency/Blockchain, Autonomous Driving, Artificial Intelligence and VR/AR. It looks as if any single technology alone is about to shake up multi-billions addressable markets. Historically speaking, when capital meets innovative and sound ideas, they increase productivity and create welfare for humanity, just as elegant as Hydrogen reacts to Oxygen to produce vital H2O to earth life. If social wealth can be boosted by increased productivity and, more importantly, redistributed properly, humanity will spend less time on creating value while more time on consuming it. It took human thousands of years to go from working all year long to 6 days a week, and another hundred from 6 days to 5 days a week. It may take a few decades from now to 4 days weeks if AI lives up its expectation. That could imply a larger than expected future earning across industry, thus further justifying the current market valuation.

But, what if capital (Hydrogen) is oversupplied cheaply? Well, things will be fine until a flare of match shows up. Looking at venture capital market this year thus far, are Softbank's 100 Billion Vision fund, Social Capital's IPO alternative SPAC (ticker: IPOA), and Paris Hilton's Lydian ICO pumping Hydrogen now? Possibly, but I suspect it may be <u>just the beginning of it</u>. This means "the rest of this cycle" could be stretched much further. The key takeaway for me as public market investors is that <u>it will likely get</u>

harder and harder to get reasonable deals in these spaces as the rosy expectation will be all built into market valuation in previous financing rounds already.

Been said, this by no means indicates any negative view towards mentioned technologies. In fact, as you may know already, I myself am an early Bitcoin adopter, having invested in a small portion of my net worth in late 2013. Additionally, my view for bubble has always been dialectical. Although dreadful for suffering generation, bubbles usually leave heritage to future generations. Furthermore, the less perishable the economic outputs during the bubble are, the more valuable the heritage will be. The 1920s real estate bubble left Florida with well-built roads and cities; the dotcom bubble left our generation with valuable business concepts that were just ahead of technologies then; regardless how this "China bubble" will be reviewed historically, it did build world class infrastructures that could benefit the country decades to go. I am sure this round of industrial revolution will do our species long term good with or without a bubble.

Portfolio Updates

Discussing prospects of humanity is exciting, but when it comes to deploying our capital I may be boring, yet hopefully safe. In this quarter, we have put our cash to work in below 3 positions.

Coty (Ticker: COTY)

COTY is a distressed assets category position. Coty, a global beauty products player, had done the deal of its life acquiring P&G's beauty business for $12.5 billion in Oct. 2016. Since then, its share lost 30% of its value, mainly due to the performance of both top line growth and expense cutting failed the expectation set by the road show. Its financial reporting is not any clearer either than other post major mergers for investors to figure out the details. It's not surprising that Coty is even hated by many value investors.

Tao – Beauty products solve physiological needs of being attractive to opposite sex, similar to other mild stimulants products like alcohol, caffeine and nicotine. Because of the value of the products is mainly derived from the perception of the products (i.e. branding), they would be the last castles for private label or low cost disrupters to conquer in consumer products kingdom (if that happens at all).
Meteorology – Beauty sector generally is countercyclical, warranted applicable only to strong brands.
Topography – This is the most important, yet the most controversial, factor for Coty. I believe Coty has narrow moats in some Luxury & Professional brands, and rest of the brands need either further investment (to rebuild moats) or divesture altogether. Management did realize it and is trying to rebuild these starved brands (Covergirl, Clairol etc.). On the other hand, management is also aggressively cutting cost to make a more efficient operation. Additionally, Coty doesn't have sound financial position. Due to the debt funded acquisition, it has 60% long term debt on liability side and 75% intangible on asset side.
Commander: major owner JAB holding (owns about 37%) is proven to be a great capital allocator. Just a side note, JAB appears to be a believer of stability of human's physiological needs indicated by their

holdings of coffee companies (caffeine), Durex (sex) and Enfamil (infant food). Coty's CEO Camillo Pane is only 47, growing up from another JAB owned consumer products giant Reckitt Benckiser's marketing department. Although Pane's expertise of beauty/fashion is still unclear, he seems to have strong background and understanding of brand building, which is crucial for the execution of the turnaround. System: This is Coty's most impressive aspect among these 5 factors, partly because of JAB Holding's positive influence over its corporate governance. In their proxy statement, I see numerous unique incentive designs to align management's interest with shareholders': 1) 5-year cliff vesting (means management gets nothing until 5 years after the grant), 2) matching options/preferred if management makes open market purchases, 3) management has $value minimal holding requirement (e.g. CEO has to hold 5* base salary and other executives 3* base, which means management will have to pay directly out of their pocket to maintain $ holding if price slides significantly), 4) convex performance incentive curve (which encourages outperforming target rather than the concave curve encouraging meeting the target). When I see some unique business practice like this, I ask question whether all others adopting the same practice would make the society better or worse. In this case, my view is: it would be much better if all public companies adopt these practices.

Price: During the P&G merger, management had set a $1.53 EPS by 2020. Although it's not realistic assuming they can achieve it without efforts anymore, management has reiterated their commitment on this target. A more conservative scenario is that Coty, in long run, can realize the cost reduction synergy, yet with a far below expectation Consumer line. Even in that case, I estimate Coty should still be able generate $1 EPS and it is not unreasonable to imply a $13+ price (20~% downside, adjusted for dividend yield). With such pessimistic assumption, any positive surprises in long run can take care of the upside, but we will need to wait patiently to see.

Overall, Coty is a polarized situation, very strong on Commander and System and very poor on Topography. The combination of high leverage and high intangible assets usually is an immediate turn off for me. However, it is admittedly less of a concern for counter-cyclical industry (which is basically the premise of the LBO industry). My balanced view is that Mr. Market may be too bold to call thoughtful owner and skin-in-the-game management totally dumb, thus may susceptible to mistake. We have built a modest position and will closely watch how future folds out.

NACCO Industries (Ticker: NC)

NC is a typical special situation category play. Parent NACCO Industries is a coal miner, and the spinoff entity Hamilton Beach Brands (ticker: HBB) is a small kitchen appliance designer and distributor. It initially appeared attractive to me because 1) the difficulty to find HBB's investors relation information (implying under-followed) and 2) the premier market position of Hamilton Beach products.

From Tao, and Meteorology perspectives, HBB operates in a very counter-cyclical and stable niche market. Although lacking of obvious growth opportunity, HBB has wide moat in its leading market position and customer loyalty. Its strong free cash flow yield (estimated over 10%), and small size ($500M market cap) makes it a decent target for strategic acquirers.

Overall, it is an easily comprehensible opportunity with limited uncertainty. Since "investing is about figuring out material information you know now that others don't but eventually will", I expect it to work out in short run as wider investing community starts to look into it (analyst coverage initiation etc.)

Gilead Sciences (Ticker: GILD)

GILD is a great operation at reasonable price category position. Gilead is a biopharmaceutical company currently has two major lines of products, one for HIV and one for HCV (Hepatitis C). From first glance, its share appears cheap in almost every measure, which usually means something is wrong with the business. The main "problem" for GILD in this case is that they found a cure to HCV, and Mr. Market thinks it's an unattractive business. That is a counterintuitive argument because capital market's existential purpose is to reallocate capital flow to create larger human welfare.

Tao – The fact GILD created cure but not customers of HCV is a good base for awareness of societal value. Additionally, based on my research on employee reviews in Glassdoor, I concluded GILD a very mission oriented however demanding employer.
Meteorology – Health care industries in US are undergoing a period of scrutiny due to the high pricing inducing ecosystem. Although potential regulatory change may affect all pharmaceutical companies, I see the outlook as neutral.
Topography – One thing very attractive is that HIV business is a very wide moat business in foreseeable future (by creating modified version of drug with longer patent protection). There are controversies over these types of patent-extending practices, however my view is that is a systematic problem policy maker need to address. Using reasonable assumptions, I estimate HIV business alone could worth $50/share.
Commander – One good trait of GILD's management is lumpy decision making in capital allocation (e.g. $11 billion acquisition Pharmasset in 2011 eventually leading to HCV cure). This is the equivalent of "concentrated betting", and I think it is a good practice for medicine research industry.
System – Among negative reviews in Glassdoor, many complained underpaid. The reason is plausibly because the company encourages equity compensation, which however may be underwater due to the price slide in recent years. I see GILD's system as neutral.

Additional consideration is the new $11.9 billion acquisition this past August of Kite Pharma, who specializes in CAR-T treatment for certain types of cancer (non-Hodgkin lymphoma). Aiming cancer is another sign of big mission (solving hardest problem to benefit the most suffering patients). It is also another lumpy investment. Although the ability to execute an acquisition is not a big concern based on GILD's track records, I see some uncertainty around the fact that cancer, different than HIV and HCV, is not a virus disease.

Overall, GILD is a well-run firm with strong mission traded at a price as if the company has close to 0 probability of succeeding in future researches. Although Kite Pharma CAR-T outcome may be the price driver for near future, I think GILD has very good setup to solve hard-to-cure disease and deliver financial return for shareholders in long run.

Performance Commentary

As mentioned before, the composite, time-weighted return of Tao Value's strategy was 5.83% for the quarter ended September 30, 2017. This brings our YTD return to +18.67%, compared to ACWI's YTD return of +17.60%. One thing to note is that at the quarter end we still have about 5% cash at hand.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year/YTD
2017	+1.94	+2.34	+0.33	+2.80	+4.14	+0.07	+2.65	+1.76	+1.31				+18.67
Since Inception (*January 1st, 2017)													+18.67

Contributors & Detractors

This quarter, our largest contributor is Dell Technologies (ticker: DVMT). I will elaborate it in next section as it is now our 3rd largest holding by Q3 2017.

The largest detractor this quarter is COTY. As mentioned before, I believe it is punished by the upfront bad news and uncertainty after a major acquisition. We see it as a very well incentivized and right-minded management try to navigate through a tough time in a disruption-resistant industry.

ELON, the largest detractor last quarter, make to detractor list this quarter again. However, we don't see fundamental changes that may affect my thesis. The lesson is that I could have been more patient waiting for more favorable prices when building up the position.

Contributors		Detractors	
Position	*Performance (bps)*	*Position*	*Performance (bps)*
Long DVMT	192	Long COTY	-73
Long VST	82	Long NXRT	-49
Long CYOU	79	Long ELON	-32

Top 3 Positions

Changes of top 3 positions this quarter are mainly due to two actions: 1) deployment of about 15% in cash to three new positions and 2) trimming CYOU position by half at a favorable price $43.54 (well above the proposed buyout offer price of $42.1) on 7/27/2017.

Credit Acceptance (Ticker: CACC) – Credit Acceptance is now our largest holding standing at 12%. As mentioned in last quarter's letter, CACC is a "great operation at reasonable price". There is no factual change of the business intrinsic value however we will be actively monitoring industry and regulatory trends.

Alphabet (Ticker: GOOG) – GOOG is a long term holding from the “great operation at reasonable price” category, standing at 11% of our portfolio. Google (the core ad business) firmly grasps the entrance of the information world, and it has taken bold acquisitions and flawless execution widening its moat (Android for mobile entrance, Chrome for desktop entrance, Youtube for video entrance). In a few years, human may not need mouse or keyboard to use internet, and Google’s R&D for voice and image searches follows the same long-term vision of further fortifying the information world gateway. With the help of a Wall Street veteran CFO, Ruth Porat, Alphabet also became much more “comprehensible” for valuation. Using sum of parts valuation, one could find one or more parts priced at bargain even assuming fully expensing investments in moon-shooting “Other Bets” (including driverless car, quantum computing, etc.). It also has the highest sense of societal value in tech industry in my opinion.

Dell Technologies (Ticker: DVMT) – DVMT is a “special situation” idea standing at 9% of our portfolio. It is a tracking stock (spun out from the Dell acquiring EMC deal) for VMWare, a virtual machine software company. VMware is a leading player in virtual machine software market with wide, yet narrowing, moat. Although DMVT is fully entitled to the sound fundamental of VMWare, DVMT carries a 30~% discount to VMWare share. Except for the bankruptcy risk of Dell, DVMT really has no difference than VMW. An implied 30% Dell bankruptcy certainly seems unrealistic (which can be verified by Dell’s 7 out of 8 bonds trading above par).

Final Note

It has been a lengthy update for the elaboration on the three new positions. Generally, I don’t like swing so often in a quarter. Nonetheless, I believe all of them offer unique and attractive risk/reward tradeoff worth exploiting. Thank you for reading and I look forward to reporting to you next quarter.