Tao Value Q2 2018 Letter

July 21th, 2018

For the quarter ended June 30th, 2018, we recorded a return of +7.09%, compared to +0.30% of MSCI All Country World Index (ACWI). What happened this quarter is not too different than the last, where the strategy deviated drastically from the broad market. It is something we will see often by nature, but the intrinsic value of our holdings of businesses didn't (and possibly couldn't) change that much in a quarter. We must keep in might that, just as the illusion of "loss" last quarter, some of our "gains" this quarter may be illusion too.

	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%	+4.69%	+1.34%	+1.60%	**+27.91%**
2018	+2.07%	-3.86%	-3.74%	-0.80%	+4.81%	+2.99%							**+1.16%**
Since Inception (*January 1st, 2017)													**+29.39%**
Annualized													**+18.74%**

Contributors & Detractors

Contributors		Detractors	
Position	*Performance (bps)*	*Position*	*Performance (bps)*
Long ELON	236	Long COTY	-91
Long DVMT	129	Long C09	-58
Long NXRT	125	Long AINC	-45

This quarter, our largest contributor is Echelon (ticker: ELON) of +236 bps. The second and third contributors are Dell Technology Class V (ticker: DVMT) and NexPoint Residential Trust (ticker: NXRT), contributing +129 bps & +125 bps respectively.

Our patience with Echelon got paid off this quarter. On 6/29/2018, Adesto announced a deal to acquire Echelon for $45 million (that is $8.5 per share, a 104% premium over its last close pre-announcement). Based premium over market price, it seems to be a good deal for shareholders. However, looking from business perspective, even assuming liquidation, Echelon has about $16 million "net-net" value (100% * cash & short-term investments + 50% * rest current assets – 100% * all liability). Also note off the book, Echelon has considerable net operating loss carry-forwards (or NOLs, which can be used to offset future taxes if a profitable company buys them), amounting $261 million for federal and $107 million for state. Under the new tax code, this piece could worth north of $60 million (assuming full utilization), and possibly more if tax code reverts in future. Leaving everything else, it's already a great deal for Adesto.

We have been staying put on our DVMT position and watching Mr. Market to realize its overaction. The stock recovered almost fully to the last high this quarter. I will elaborate more in our top positions section below.

There is not much operating update for NXRT. The gain this quarter is merely Mr. Market's reversion to rational from last quarter's overselling. As I mentioned before, I see Nexpoint as a flipper, thus I am more interested in understanding how well they do on assets turnover. So far this year, they have done no acquisition and sold one property. Granted real estate transactions are lumpy, deal flow this year is slower than the last (through FY 2017, they had done 3 acquisitions and 6 dispositions). The most recent published NAV estimate reflects this slowness, standing at $30.46 per share as of Q1 18, up marginally from Q4 17's $29.98.

The largest detractor this quarter is Coty (ticker: COTY) with -91 bps. It was followed by City Developments Ltd (ticker: C09) and Ashford Inc. (ticker: AINC), contributing -58 bps and -45 bps respectively.

Coty has the same old story that consumer beauty segment is not performing well and it also had to lift its estimate of one-off cost from the deal by $100 million. We are prepared for a prolonged turnaround and will keep monitoring it. City Developments, a Singapore based global real estate developer and hotel operator, is a small position we started in early 2017 for playing a revived real estate market in Singapore. It is the highest quality player in that market with net cash balance sheet and highest value of land bank/inventory. There is no operational side of deterioration, and the price drop may be due to expected rigid regulation from Singapore government. Ashford is a new position this quarter and I will elaborate in Portfolio Update section below.

Top 3 Positions

There is no change in our top positions. Credit Acceptance (ticker: CACC) and Alphabet (ticker: GOOG) remain our top two holdings. Dell Technology Class V (ticker: DVMT) returned to third by its price recovery.

Sitting tight on our large DVMT position (ranging from 8-10% of the portfolio from time to time) through this season of Dell's show is not as easy as it looks. In retrospect, two things helped: 1) having a concise, one-paragraph summary of original thesis so I can easily revisit when new information obscures the reality; and 2) having a probabilistic view of the world. The original reason for taking a naked long on DVMT is to ride on the growth of the VMWare, so that time passing (for VMW's growth) and spread narrowing can work for us in conjunction. With both forces, even with management "stealing" some from me, I expect I will still have sufficient "left over" to make a decent return. After evaluating the situation upon the strategic review announcement back in Q1, I concluded it did not fundamentally change my thesis, rather it just fast-forwarded the reality to the "judgement" day for this position. The next step is to re-access what the "judgement" would turn out to be given probability of various outcomes and potential impact of each outcome. My conclusion was DVMT would "more possibly be priced favorably than adversely" from then.

Reality quickly converged to my assessment with below key progresses this past quarter:

- Business media reported on April 16, 2018 that Dell will back away from reverse merging with VMW directly;
- On May 17, 2018, Dell announced granting a vote to unaffiliated shareholders for any deal;
- Business media reported on May 21, 2018 that renown activists (Icahn & Singer) hold significant tracker shares.

Most recently on July 2, 2018, Dell announced their initial proposal of the deal of combining with the tracker, valuing DMVT $109, however with a combination of cash and Dell Class C shares. This is a complex deal, and could worth a full write up to explain it in detail. Now with updated assessment of a narrowed range of two possible outcomes (DVMT shareholders to take deal or Dell to go traditional IPO and convert tracker later), my decision is still to do nothing and watch how the judgement folds out.

Portfolio Updates

Ashford Inc. (ticker: AINC)

Ashford is a new Special Situation position this quarter. It is borrowed from Greenhaven Road Capital's manager, Scott Miller who shares his ideas frequently with public.

Ashford was interesting enough when it was traded around $90 based on Miller's thesis. it was created from the spinoff of the asset management arm from the old Ashford in late 2014, along with other two public REITs, Ashford Hospitality Trust (ticker: AHT) & Braemar Hotels & Resorts (f.k.a Ashford Prime, ticker: BHR). The founder CEO of the old Ashford, Monty Bennett, remained as CEO & Chairman for all three companies after the spinoff but subsequently transitioned out of two REITs' CEO role (Nov 2016 for BHR & Feb 2017 for AHT). Furthermore, when given the chance to restate his deferred compensation from the old Ashford, Bennett elected to restate them to be all in AINC. The 195,579 shares Bennett restated is significant, representing about 10% of the company before Remington deal, and 6% after assuming full dilution by exercised convertibles. This package is also heavily deferred, which will only start to vest from 2020 in a 5 years straight line schedule. Finally, Bennett has been wanting to repackage his hotel project management company, Remington, into AINC since the spinoff. It has been very clear Bennett wanted the upside of AINC (and to his own greatest advantage, convertible debt), rather than cash, as currency for the deal. As you may already sense, the corporate governance is not pretty to say the least and there are many red flags for conflict of interests. However, the heavily tilted incentive system appears very appealing that I find comfortable to join the same side.

It just got more interesting on the news of merging with Remington, a private company also owned by the CEO & Chairman Monty Bennett and his family. Starting with Mr. Market's valuation of AINC before deal announcement around $95, we know the deal dilutes 36% of the company on fully exercised basis, which will leave us about $61 for the ex-ante AINC per share. With AINC currently trading around $66, Mr. Market basically values Remington's 16 million LTM EBITDA business for about $5 per fully diluted share, or $18 million Enterprise Value. Both valuations cannot be right at the same time, and I believe Mr. Market is more possibly wrong on Remington due to overaction to poor corporate governance.

So how bad is this deal itself in deed? On cash basis, it's priced 12.5 * EBITDA, probably high end of a reasonable band. On share basis, essentially AINC paid 1/3 of the company for 72% more EBITDA, not a bad deal in fact. Warranted there are optimistic assumptions and aggressive adjustment for the EBITDA, I still don't think it is such a value destructing deal as perceived by Mr. Market. We have built a median size position on AINC.

Tencent (ticker: 700 HK) & JD (ticker: JD)

Both companies are in my watchlist for years, which means they both already well passed my Sun Tze five factors check. I believe the price drop early this year created opportunities for us to participate in their growth at a reasonable price. Both behemoths are well known to general public, and all of us may have used their products or services in our daily life.

In my opinion, in addition to its main gaming business, Tencent already has many new exciting avenues (WeChat payment could be the next Visa, for example), but below are two interesting progresses I believe is not fully comprehended by market.

1) Investing arm with great bargain power. This revelation came with the "ripped off" feeling when Tencent bought a 34% of Huya at a steal price ($7.16 per share) from one of our high conviction holdings YY, right before its spinoff IPO. For reference, Huya is currently traded around $38 just 4 months after that deal. Due to its scale and ecosystem, I believe Tencent would have similar negotiation power in any deal they want to strike. The next logical check is how good a VC investor Tencent is. Executive Director Chi Ping Lau, who held former Chief Strategy and Investment Officer, along with the current head of Tencent Investment Chaohui Li, appear to be rational thinkers with some disciplines. They will need more time to prove it.
2) Secular change of gaming industry monetization model. The prevalent bear case for Tencent is that its gaming market is reaching its ceiling and bound to decline. It is true that nothing grows to the sky. But one important observation I have is that gaming industry globally is experiencing a transformation of monetization model. Game developers now not only make games that people want to play, but also people want to watch, thus opening up a new addressable market which is not to dissimilar from the sports industry. With the rise of gaming streaming, I believe it could be the birth of a new form of entertainment. I also believe game developers & publishers like Tencent, is positioned very well to monetize within this value chain. In the end, monetization from users may stall or decline, but this new type of entertainment revenue is something quite natural to transpire.

JD's thesis is heavily around its founder CEO, Richard Liu. By my assessment, Liu processes some very rare characteristics for a Chinese entrepreneur. Liu holds the highest integrity in conducting business, and has extraordinary long-term visions. Both of which are verified and backed by two investors I highly respect, Lei Zhang of Hillhouse and Xin Xu of Capital Today, with significant investments. With JD's price reached 52 weeks low last quarter, I feel comfortable to initiate a position.

Also need to mention, since I have very long expected holding period for both companies, I decided to take a more patient approach in building up my desired size for these two positions.

<u>Exits</u>

We have trimmed our holding of SOHU. I'm still positive in its value. However, with a re-evaluated system factor, I think this opportunity deserves a smaller allocation in our portfolio.

General and Market Commentary

When my information changes, I alter my conclusions. What do you do, sir?

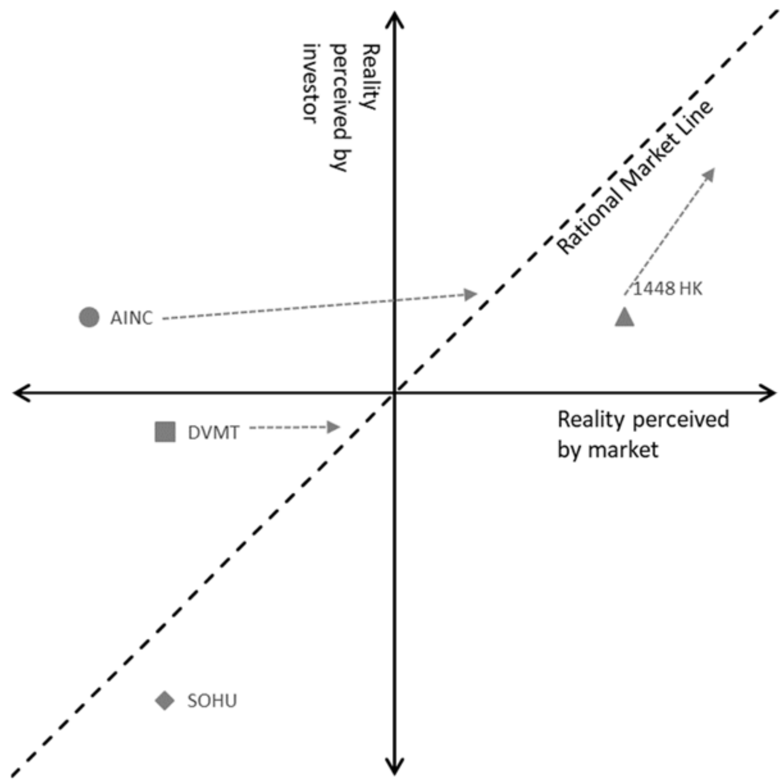
- John Maynard Keynes

The wide swing of our portfolio in past two quarters served a great chance for me to reflect on decision making process. In my theory, <u>opinion</u> and <u>reality</u> are intertwined and mutually evolving. Sometimes it is very hard to segregate one from the other. Let's take an example, a company may need to borrow using its equity as collateral to fund operation. Suppose its market price suddenly suffers a drastic drop even the business still operates well. The lender will then ask for more collateral or freeze the lending facility which creates liquidity crisis and could eventually bankrupt the company. Mr. Market's opinion, even it's not "right" in this case, evolves into reality. I think it is <u>the ability to grasp what's "real" (rather than just what's "right")</u> that distinguishes great investors from average ones.

To make my decision-making process more repeatable and less bias-prone, I have below process in actively evaluating all our holdings given any time:

- Identify all new information that constitutes reality (e.g. operational updates), or perception that are undergoing evolution to reality (e.g. deal proposal)
- Update potential future outcomes and their probabilities, given above new information
- Calculate a weighted average of expected value, given probability and outcomes above

That would give the reality as I perceive, then I will compare it to the reality perceived by Market, which is reflected by market price. Each investment then can be plotted in below quadrant. When market have same the perception as mine, I deem it's rational (the 45-degree dotted line). In general, we can see things above the rational market line as "undervalued" and things under as "overvalued".



I will illustrate how I apply this framework using a few past and current examples:

- When Dell announced strategic review last quarter, I deemed DVMT move just slightly negative on my reality scale. Market however thought it move significantly negative. I decided to do nothing and expect it to move left ward back to rational line;
- AINC has a very strong incentive system, and the deal of acquiring Remington is not completely bad. When I think it positively and market thinks it very negatively, I buy or add;
- Fu Shou Yuan (1448 HK) didn't have impressive operation updates this past quarter, however the price appreciated 14%. Given it's in my bucket of "Great Operation at Reasonable Price", I expect it will eventually move right upward toward the rational line and I decide to keep holding. If similar situation happens for other two buckets ("Distressed" and "Special Situation"), I may think of exiting;
- In light of SOHU's CEO's decision of calling lower ball price for a previously announced MBO offer for Changyou, I changed my view of his "shareholder ethic", and regard the investment significantly deteriorated. Market agree with me (maybe for different reasons though), and we decided to trim it at a loss.

With such a decision-making framework, I hope could do better in separating illusion from reality and remain as rational as possible.

Final Note

If you take market price as reality, the volatility could be thrilling. I believe that is one main reason to cause people to lose their wealth by irrational decisions (buy high and sell low). I hope the elaboration of my decision-making process help you to understand better how I try to avoid that very bias. Additionally, no matter the illusion is temporarily favorable or adverse, my own wealth is always alongside with yours. With that been said, I look forward to reporting to you next quarter.