LONGRIVER PARTNERS FUND
2ND QUARTER 2024

12th July, 2024

Dear Partners,

Net returns for the Longriver Partners Fund ("the Fund") were 1.3% over the quarter. This brings net returns for the year to date and since inception to 15.3% and 27.9%, respectively. Over the same periods, our benchmark, the MSCI AC World USD Index, has returned 2.9%, 11.3% and 36.0%, respectively.

Our investment strategy is to ride the long-term value created by our companies, so I encourage you to take a similarly long-term view of your investment in the Fund. Consider it as you would an investment in real estate or a private company – assets for which you wouldn't receive a volatile quarterly valuation.

TSMC AND NVIDIA:

TSMC has contributed the lion's share of our gains this year, as the rush to invest in Generative A.I. ("GenAI") has led to a cyclical recovery in demand and fab utilisation. I can assure you that I in no way predicted GenAI or what it would mean for TSMC. However, it was a safe bet that when the cycle turned, for whatever reason, all roads would lead back to TSMC.

Let me explain. It took TSMC decades to earn its customers' trust and win the leading edge (i.e. to become uniquely capable of manufacturing the smallest and most power-efficient transistors). It is now the only independent foundry of its scale and sophistication which can serve customers free of conflict, no matter what they're designing. Mr. Market has come around to my view: I wrote to you in the third quarter of last year that TSMC's ADR premium collapsed in the wake of market fears. That premium has since expanded to a twenty-year high as demand surges and TSMC moots raising prices (link).

Before I run any victory laps, however, I need to make a confession: I am kicking myself for not investing in Nvidia, one of TSMC's largest clients. In June 2023, I wrote about how data centre capex budgets were following the tectonic shift in logic semiconductors from CPUs to GPUs, a trend accelerated by the advent of GenAI (link). I concluded this would be negative for Intel, ambiguous for AMD and wonderful for Nvidia – the industry's three main suppliers.

I sold our position in AMD but never bought Nvidia, though it was squarely in my wheelhouse. I can only blame myself: the stock had already risen some 300% from its October 2022 low, so I simply ruled it out. I failed a fundamental test and confused price with value, as each subsequent quarter of Nvidia's record earnings has hammered home to me. This has cost us both in absolute and relative performance, especially given Nvidia's breathtaking returns and large weight in our benchmark.

BIG TECH, SEMIS AND GEN AI:

Nvidia's outsized impact is emblematic of the market today: the world's biggest companies are driving most of the stock market's gains as their growth accelerates and valuation expands. According to Berenberg Research, the aggregate earnings of Big Tech (i.e. Microsoft, Apple, Alphabet, Amazon and Meta), Nvidia and Tesla have increased some five times since 2013. In contrast, the aggregate earnings of the remaining 493 stocks which constitute the S&P500 index today have not even doubled over the same period. Ditto for the STOXX Europe 600, an index of Western European companies.

I highlight this for three reasons. First, to remind you of the power of Big Tech's business models. The attention they command and convenience they offer make them the gatekeepers of the digital economy. As long as more of our lives are spent online or working with digital tools, why shouldn't their earnings continue to grow? Second, to observe that Big Tech's earnings power has been persistently underestimated, as evidenced by their stocks' outperformance year after year. Mental models emphasising mean-reversion have not worked. Finally, to emphasise that the investment cycle currently driving Nvidia and TSMC's earnings is dependent to a large degree on the returns Big Tech on their investment in GenAI.

The GenAI investment cycle was sparked by Big Tech's fears that this new technology could upset their cosy competitive equilibrium. They are now doubling down, as communicated in their first quarter results. Per Morgan Stanley, Amazon and Meta (in which we're invested), together with Alphabet and Microsoft, will increase investment in compute from a combined USD119bn in 2023 to an estimated USD177bn in 2024 and USD195bn in 2025. That is a staggering USD76 billion increase over two years, equal to a 64% rise. By any metric, this is surely one of the largest investment programmes ever undertaken by a group of private companies.

Big Tech is well-positioned to take the risk: they have the best engineering talent, global distribution and the cash reserves to pay for it. Their transition from asset-light software companies to asset-less-light computing powerhouses began years ago as they ramped up client cloud services and integrated compute-heavy machine learning into their services. So, they have the experience and confidence to execute similar ramps of physical infrastructure and take new products to market. Mark Zuckerberg said as much on Meta's last earnings call: "we have a playbook for this".

IF YOU BUILD IT, WILL THEY COME?

Investment at these levels can (should?) only be sustained if it is profitable, and we have yet to see evidence of that. David Cahn of Sequoia, a venture capital firm, uses simple back-of-the-envelope calculations to estimate USD600bn incremental revenue is needed to justify the investment made to date (link). Compare that to OpenAI's USD3.4bn annualised revenue run-rate, up 100% year-on-year, as reported by The Information last month (link). These are very, very early days, of course. But there is a long way to go, even if you believe, like I do, that GenAI will change the way we work for the better.

The other ten-trillion-dollar question is, where will the value of this innovation accrue: with the hardware, infrastructure, platforms or applications? It's not clear yet, at least not to me. Amazon and Microsoft reported that demand for GenAI compute has accelerated their cloud computing revenue growth. Microsoft reported 1.8m paying subscribers to its Copilot GenAI service, launched in November 2023. It's a great start, but it remains just that, a start. Conversely, Alphabet's Search product hasn't yet lost market share to GenAI. Considering the earlier panic that it would lose its monopoly, this might reasonably be considered a win.

OpenAI has captured the zeitgeist and the lion's share of revenue spent on models, but will competition from a proliferation of pretenders preclude any pricing power? Meta's Llama 3 model is open-source and reportedly very good, for example (link). The terms of OpenAI's recent deal with Apple were very much in the latter's favour, suggesting that either OpenAI has a 'go-for-broke' growth strategy or Apple's distribution remains more valuable than any single feature. Speaking of Apple, its "Apple Intelligence" product heralds a repeat of Apple's own playbook to leverage its control of the customer to ride everyone else's capex.

Will Nvidia continue to command a King's ransom for its GPUs? After all, its rapid product cadence means that today's chips will be obsolete within 2-3 years. However, supply constraints are easing, and the semiconductor market is notorious for how quickly it can fall into overcapacity. Nvidia's sky-high profits are also the perfect incentive for competitors and customers to find alternatives, especially as the focus moves from training to inference (i.e. from building models to using them).

Another possibility is that competition ensures that the most value accrues to us, the consumers. You can subscribe to

ChatGPT for USD20 a month, which is incredible value considering the cost of the services ChatGPT can replace. Moreover, the quality and speed of GenAI models continue to improve as companies reduce their own inference costs and pass on the savings (link).

I have no reason to doubt that Big Tech's dominance will continue. Along with TSMC, Amazon and Meta remain core holdings in the Fund because I trust these companies to allocate capital well and astutely navigate the future on our behalf. Nonetheless, share prices ultimately follow the returns companies earn on their capital. The question is, therefore, how profitable will this outsized investment in GenAI be? As you can tell by the number of questions I raise, there's a high degree of uncertainty. Given this uncertainty, the vast sums involved and high valuations, there is good reason to be cautious.

PINDUODUO: COSTCO + DISNEYLAND

The great thing about the Fund's global mandate is that there's always a pocket of cheap stocks somewhere.

This year, I've added to our investment in Pinduoduo, the Chinese eCommerce company. Suffice it to say that Pinduoduo is one of the most polarising companies I've come across. At home in China, it has entrenched itself into the daily lives of almost a billion people. As it built trust and scale, it laddered up from selling cheap fruit and unbranded toilet paper to leading brands like Apple, L'Oreal and Dyson (link). It continues to take market share from hamstrung incumbents Alibaba and J.D. as urban consumers trade down and rural consumers trade up.

Overseas, however, bashing Pinduoduo's international arm Temu has become a popular pastime (Saturday Night Live did the best job, in my opinion (link)). The Financial Times' Dan McCrum, who covered the Wirecard fraud, calls Temu a "Chinese flea-market" (link) and has insinuated (poorly) that Pinduoduo's books are dodgy (link). The French government voted to penalise 'fast fashion' platforms like Temu, lest they "[wipe] out everything that is not luxury in the market", as one activist put it (link). In fact, it was the condescension towards Temu last year which prompted me to invest. I had seen it before from consumers in Beijing and Shanghai c. 2019-2020 as Pinduoduo began its meteoric rise.

I concede that Pinduoduo's secretive nature is not winning the commentariat's hearts and minds. Because of hyper-competition in China, it plays its cards very close to its chest. It does not disclose its Gross Merchandise Value – the value of goods bought and sold on its platform, as distinct from its own revenue – and its financial reports shoehorn several incongruous businesses into two meaningless operating segments. Its earnings calls are a lesson in doublespeak. It sits on a huge cash pile and is ambitiously investing at a time when its Chinese peers are skittishly cutting back and returning capital. This is not a conventional company.

Yet, you don't have to squint to see that Pinduoduo is doing exactly what it always set out to do: "be a combination of Costco and Disneyland (value-for-money and entertainment combined)", as Founder Colin Huang Zhen wrote in the company's inaugural shareholder letter (link).

Pinduoduo's model is simple: it aggregates and concentrates a tremendous amount of consumer demand into a limited selection of SKUs, then sends these orders directly to factories to secure the lowest prices – a model it calls consumer-to-manufacturer ("C2M"). If this sounds familiar, it's because it is highly analogous to Costco – only that Pinduoduo does it online, where it can operate at an extreme scale. Pinduoduo offers rewards and discounts for completing little games within its app, but the real thrill comes from scrolling for bargains in its algorithmically powered feed.

A BUSINESS MODEL BUILT ON OVERCAPACITY:

Outside of China, people often ask how Pinduoduo can sell products for so much less than they expect. The answer has two parts. First, for now, Pinduoduo is subsidising Temu users to win market share and build habits. Second, as described above, Pinduoduo concentrates demand on a small set of SKUs to get the lowest prices directly from manufacturers.

It's easy to conflate low prices with poor quality. But for much of its modern history, China suffered from the opposite: *high prices* and poor quality. Lei Jun, who founded Xiaomi in 2010, articulated the problem to a group of American students at a talk in 2017 (link):

In my opinion, the fundamental problem with China's industry is its low efficiency. That is, for every product we have in the market, there are too many channels to go through before the products could finally reach the hand of the consumers. That's the reason for the high price. Many of you here are Yale alumni. What you bought in the U.S. are probably made in China as well, but they are of better price and quality. That confuses me a lot; when what we made in China crosses the Pacific to the U.S., they are of higher quality and lower price. That made me wonder, how could I improve domestic business efficiency?

Only when we improve business efficiency can we make our products better. I don't believe that Chinese people don't have the craftsman's spirit, neither do I believe that Chinese people lack innovation. I think we can make great products. When I found out this problem, I decided to cut out the middlemen as much as I could, and use the saved money for research and innovation.

Factories were willing to work with Xiaomi on its terms because their business was so bad in the wake of the Chinese government's RMB4tn 2008 stimulus, much of which was misallocated to additional industrial capacity. Xiaomi used the internet to bypass traditional retail channels and go directly from the factories to consumers. Colin Huang surely learned from this when he founded Pinduoduo in 2015, though he opted to become a platform rather than design his own branded goods like Xiaomi. China's overcapacity problem hasn't gone away since then; if anything, it's become worse.

Despite Pinduoduo's efforts to work with merchants to improve their own supply chains, it would be naive to think it has perfectly solved for quality and low prices. The company, therefore, fights for consumers' trust by acting heavily in their favour. It rewards good quality products with more traffic and penalises poor quality products with 'no questions' refunds and severe fines. Temu offers a semi-managed consignment model to facilitate overseas sales (link). To incentivise merchants to supply only what they think will sell well, Temu charges punitive storage fees after a set period and will even unilaterally dispose of unsold items.

Given these onerous constraints and Pinduoduo's commitment to low prices (link), a crucial question is whether merchants on the platform actually make money. There is some obvious advice online for how to succeed: choose your products carefully; ensure the quality of goods; accurately describe what you're selling etc. (link). Other merchants see Pinduoduo and Temu as a way to clear excess inventory – so, any sale is a good sale. Still, I suspect a power law is at play: a small group of merchants make great money while a long tail struggles to stay afloat. Quality may, therefore, be a perennial problem as this long tail cut corners to economise.

Pinduoduo itself is ruthlessly lean and performance-oriented (link). It is essentially an advertising platform for merchants: its most valuable asset is the consumer attention it commands. Revenues have grown ferociously in recent years as it has begun to monetise this attention. Near-zero marginal costs mean a high degree of operating leverage. Despite investing heavily in growth – launching grocery business Duoduo Maicai in August 2020 and Temu in September 2022 – Pinduoduo's operating margins widened from 9% in 2Q21 (its first quarter of profitability) to 30% in 1Q24, its most recent quarter.

The company also relies on third parties for fulfilment, so its asset-light model is more akin to eBay than vertically integrated peers like Amazon and Alibaba. It requires virtually no fixed investment to grow: from 2Q21 to 1Q24, operating assets increased by just 21% while revenue and operating income grew 4 and 13 times, respectively. All the cash is piling up: Pinduoduo earned more in interest income last quarter than it did in operating income during the same quarter the year prior.

BET ON THE ODDS, NOT ON THE HORSE:

When a company of Pinduoduo's quality and potential trades at 11x this year's earnings, Mr. Market is telling you he thinks something doesn't smell right. Is it a real business? Are Pinduoduo's earnings sustainable?

I hope I've answered the former question. As for the latter, Pinduoduo has continued to profitably take share this year in China. I do acknowledge, however, that competition is increasing as Alibaba and J.D. get their houses back in order. They are cutting commissions and advertising fees to encourage merchants to cut prices. But they are constrained by their existing business models, product categories, user base and merchant structures. Pinduoduo aggregates demand and achieves low prices in a fundamentally different way.

Overseas, Pinduoduo's expansion has become a question of geopolitics (link). While consumers clearly enjoy Temu's low prices, politicians don't like its Chinese origins. There is some truth in the argument that state subsidies have pushed China Inc. into a state of overcapacity, which it is now trying to export. But that same Chinese overcapacity is keeping a tight lid on global inflation at this critical juncture post-COVID.

Mr Market appears certain Temu will fail, and maybe he's right. But what if he's wrong?

Since this is an election year in America, it's instructive to remember how forecasters were widely lambasted in 2016 when they gave Hilary Clinton an 85% chance of winning the Presidential election, only to see Donald Trump snatch victory from the jaws of defeat (link). The forecasters weren't wrong, per se. Their audience simply forgot that their prediction implied Clinton also had a 15% chance of losing.

Most stock pitches work the same way (link). They emphasise all the wonderful things that make a business great, cursorily tacking on at the end a few things that could go wrong (a.k.a. "risks"). Similarly, critics of a stock rarely acknowledge what could go right. This would be wonderful if investing worked like a beauty contest, where we could get rich by buying the best companies and selling the worst. However, markets work more like the parimutuel betting system at a horse track. As legendary handicapper Steve Crist explained, winners don't bet on the horse, they bet on the odds (link).

Great investments reward us for recognising when prospects are mispriced. Pinduoduo isn't without risk. Temu must run the political gauntlet. But what if it succeeds? What if the new innovations to its model bring it closer to that nirvana of low cost and good quality (link)? What if its efforts to diversify away from America help it take root in new markets like Europe and Japan (link)? What if it eventually reaches enough scale in certain markets to attract established brands, just as Pinduoduo does in China? Even if the odds are indeed low, the payoff should more than compensate.

APPRECIATION:

I appreciate your support through another quarter. If you have any questions or concerns, please do not hesitate to let me know.

The door is always open if you wish to make additional investments in the Fund. Similarly, your referrals and recommendations are always much appreciated.

Sincerely,

Graham F. Rhodes
Founder & Portfolio Manager
Longriver Investment Partners Limited

LONGRIVER PARTNERS FUND

2ND QUARTER 2024

ABOUT THE FUND:

- Business Owner's mindset to understand and manage investment risk
- Investing globally within our few, narrow areas of expertise, drawing on insights from our experience in Asia
- Prefer long-term investments in companies with predictable business models, ambitious management and good governance, which can re-invest on our behalf at high rates of return
- Concentrated portfolio of 10-20 securities to make the most of scarce ideas, diversified across duration, industry and geography

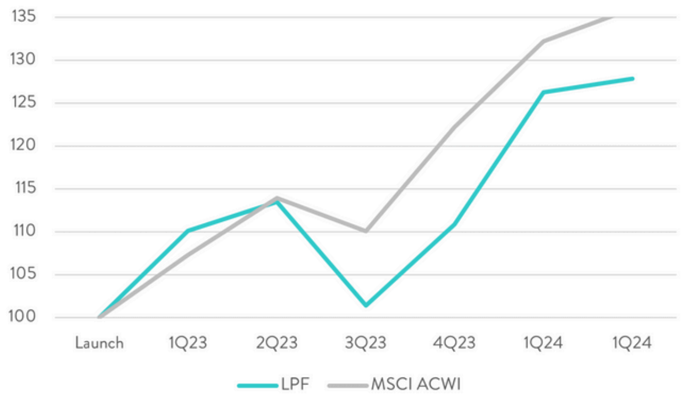
ABOUT THE MANAGER:

- Boutique Hong Kong-based manager with deep roots in Asia
- Major investors in the fund, investing for clients as we do for ourselves
- Spirit of partnership with fair fees, expenses and disclosure
- Employee ownership permits independent judgement
- Focus is always on margin of safety
- Long-term mindset allows for contrarian thinking and accumulation of competitive advantage

NET RETURNS:

Since Inception	Fund	Benchmark	Delta
Cumulative Return	27.9%	36.0%	(8.1%)
Per Annum Return	17.8%	22.8%	(5.0%)

	Q1	Q2	Q3	Q4	YTD	BMK	DELTA
2024	13.9%	1.3%	-	-	15.3%	11.3%	4.0%
2023	10.1%	3.1%	(10.7%)	9.3%	10.8%	22.2%	(11.4%)



TOP HOLDINGS & PORTFOLIO CHARACTERISTICS:

AMAZON | BFF BANK | CAIRN HOMES | FUTU | GAMES WORKSHOP | META | PDD HOLDINGS | TENCENT | TSMC | VISTRY GROUP

Portfolio:		Duration:	
Top 10 %	90%	Hypergrowth:	-%
24E PE:	23x	Growth:	56%
24E ROE:	26%	Income:	15%
24E EPSg:	20%	Cyclical:	15%
24E Yield:	3%	Cigar Butt:	11%
LTM D/E:	(30%)	Fixed Income:	-%
		Cash:	2%

Industry:		Geography:	
Digital:	20%	Global:	40%
Consumer:	39%	Asia:	11%
Financial Services:	22%	Europe:	33%
Industrial:	19%	Americas:	17%

Notes: Benchmark is the MSCI AC World USD Index. Longriver net performance figures are unaudited. Portfolio characteristics are as at 30 June 2024. Duration, Industry and Geography characteristics are as defined by the Manager. Duration represents the certainty and timing of returns, with cash at one end of the spectrum and companies which re-invest all or more of their earnings into hypergrowth at the other. Portfolio, Industry and Geography metrics exclude cash. Portfolio LTM D/E excludes Financial Services.

KEY INVESTMENT TERMS:

Manager:	Longriver Investment Partners Limited
Mandate:	Long-only, global, primarily equities
Launch:	January 3rd, 2023
Minimum:	USD100,000
Fees:	1.00% p.a. + 10% over 6% hurdle + High Water Mark
Liquidity:	Monthly subscriptions; quarterly redemptions with sixty days written notice

OPERATIONS:

Structure:	Hong Kong Open-ended Fund Company
Regulator:	Hong Kong Securities & Futures Commission
Admin.:	Sinopac Services & Solutions Limited
Custodian:	Interactive Brokers Hong Kong Limited
Auditor:	East Asia Sentinel Limited
Legal:	Charltons
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