May 3rd, 2024

Dear Partners,

The recent rise in inflation and yields may portend another bumpy period for stocks ahead. Or not! We really don't know, and our experience has taught us to not make forecasts, but rather to just buy really good risk-rewards when we see them and to hold some capital in cash when we don't, an approach that has served us well since launch. Nonetheless, I try to mentally prepare for drawdowns in advance. I regularly review our portfolio and mentally re-underwrite or try to creatively re-frame each investment. How will we react when a holding falls, and our conviction is tested?

I go back to focusing on the product that it sells, with a series of questions:
- Is the company selling a really good product, one that delivers a lot of value to its customers?
- Is the product being continually innovated on and getting better over time?
- Is the product gap vs. competition still very wide? (Understanding that some degree of catch-up by others may be unavoidable)
- Is the valuation of the company in a reasonable, ideally low, range?

If the answer to all these questions is yes, then it gives me a lot of conviction to hold.

I've written in past letters about how my experience in studying businesses has led me to conclude that companies with great products predictably outperform, with positive skew (i.e., more room for positive surprises, and fewer negative surprises). There are any number of ways to frame and discuss this, but one way I conceptualize it is that customers are sharp when it comes to their self-interest, will intuitively feel when good value is being delivered, and will eventually discover and jump through hoops if necessary to get at those products. Delivering that value to customers and capturing a piece of the value created is the essence of business; and the former needs to come first, as a means to get to the latter. My pattern recognition is clear that companies that relentlessly try to improve the customer experience and then periodically think about ways to further monetize that value perform better than companies who treat the customer experience as fixed (or, worse, as something that can be degraded a bit) and try to maximize the monetization as their main quarter-to-quarter priority.

Making a great product is very difficult in execution, requires making hard trade-offs and sacrifices, and sometimes comes in at lower margins or cost structures than existing business models – all of which makes it difficult for competitors to copy. Additionally, when we try to think out in decades, which is necessary as that's where the bulk of discounted cash flows underpinning today's equity value comes from – companies with great products today and a process for keeping them great clearly seem more sustainable in the long run than those with mediocre or bad products, regardless of how financially strong they seem in the present.

The way I formulate these questions takes a lot of inspiration from how Ted Weschler framed his investment in DaVita in his famous 2014 CNBC interview, which has stuck in my mind ever since. In that interview, he laid out his filters for investing in healthcare:
1) Does the healthcare company deliver better quality than someone could get somewhere else?
2) Does it deliver net savings to the healthcare system? In other words, is the total bill for U.S. healthcare cheaper because of the efficiency the company provides?
3) And, lastly, do you get a higher return on capital, predictable growth, and shareholder-friendly management?

Points #1 and 2 are a total focus on the product and value delivered, with shareholder value-type characteristics coming after that. He doesn't start with a typical value investor framing, which usually asks a series of questions like, does it have a moat? Does it have pricing power? Does it have high margins/returns on capital? Those are important too, but in his framing, product came first.

In terms of maintaining a focus on great products as an investor, Elon Musk says something very similar whenever he's asked for investment advice. For example, on Tesla's 2Q23 call:

"For investment advice, I say identify a company that has products you love. See if they -- does it seem like they'll continue to make good products or great products? Buy that stock and hold it. That's it. You all win. (Laugh) The reason companies exist is to make goods and services, ideally great goods and services. They don't exist for any other reason. They shouldn't. So that's why you should buy the stock of a company that makes good products and has a great future pipeline. It's common sense, actually… if provided you're confident about what that company's products or services are, when the market panics, buy; and when the market is overly exuberant, you can sell. I'm not recommending you sell Tesla (laugh), but yes, buy low, sell high."

I think Elon is entirely sincere in his belief that the reason companies exist should be to provide a great product or service, but of course also self-serving in the way he frames his investment advice – to boost the valuation of Tesla and maintain its retail cult following, arguably to their detriment. And the recent performance of Tesla's business and stock clearly shows how additional factors beyond product are relevant. But the point about putting product first remains, and is core to how I think about business – and, like Elon says, it just seems like common sense. But most public market participants seemingly don't rate product as highly in the mosaic of all the things to consider, which gives us the opportunity to sometimes take differentiated views.

Shareholder value creation is downstream from the customer/product focus needed to drive a great business (I have huge love for Jack Ma's famous saying: "Customers first, employees second, and shareholders third."). American-style public-company capitalism tends to treat shareholder value as the target; while in a philosophical sense this is entirely correct as it is the point of doing business, in execution this tends to lead to a focus on financial engineering, cost cutting (sometimes to the detriment of the product), maximum pricing, and other actions that drive short-to-medium term "value" over the harder task of re-orienting an organization to focus on the customer and continually deliver a better product. The former shareholder value-targeting approach can also lead to extremely profitable outcomes, as the long history of PE, for example, demonstrates. So this product-first philosophy is not a prescriptive way to invest. But focusing on companies with great products drives our confidence in the long-term value of those companies, and, as mentioned earlier, gives us conviction when things go against us.

So we continue onwards in our search for companies with amazing products that also have the characteristics (e.g., low valuation, high growth, barriers to competition) of being great investments we'd have conviction in. The latter is a tiny circle within a much larger one, and we do a lot of passing on ideas that initially seem promising based on our screening filter of product. Canada Goose makes great down jackets, Coupang wows customers with its super-fast and free delivery, and Freshworks delivers easy-to-use software at low prices. In each case we've decided not to invest for reasons ranging from competition to valuation to views on market growth. We of course may be wrong about the future performance of these stocks. We pass on initially promising ideas because we have many layers of filters below product before making an investment; we simply place product first, as a screener, rather than as one factor of many. We only buy companies with products we really believe in, and we run our own investment business with the same philosophy as well, to try to deliver a great product.

DPC Dash (1405 HK) – Domino's Pizza franchisee in China

DPC Dash is the Domino's master franchisee in China. It opens and operates its own stores rather than further franchising them, and pays Domino's corporate (DPZ) a 3% royalty on sales. Domino's China has a great product: it's a great-tasting pizza with excellent, dedicated delivery and a strong brand.

The investment opportunity in DPC Dash arises from some historical accidents in how Domino's was very late to develop its business in China, but in recent years hired new management, found its footing, and dramatically turned around store economics. Today, Domino's in China is operating with strong momentum but has only 835 stores, a small number when compared to that of other major QSR and QSR pizza brands there, some of which have worse brands, value propositions, and unit economics than Domino's; versus what we think is a future store opportunity of 4,000+. DPC Dash is currently guiding store growth of 31% in 2024, 32% in 2025, and ~25% in 2026.

Researching DPC Dash was a fun project, as I've had a longstanding fascination with the Domino's system and have periodically looked at its other listed franchisees (DOM LN in the UK, DMP AU in Australia/Asia/Europe, and Jubilant in India). I've also spent time trying to understand how DPZ corporate was able to 80x (!) in total return terms from December 2009. Years ago, I did a case study on DPZ, taking the years 2009-2016 when it was a 24x with dividends reinvested; I've included the takeaways from that case study in an appendix to this letter. One main takeaway was how a renewed focus on the product (a better-tasting pizza, and heavy investments into digital to drive a better online ordering experience) kicked off a flywheel that helped power its absurd returns.

History of DPC Dash

Domino's opened its first store in China in 1997, which in the grand scheme of things was not too long after Pizza Hut's first China store in 1990 (KFC 1987, McDonald's 1990). However, the franchise was owned by a Taiwanese hotel company and run by an American CEO, and it was under-managed and under-invested in from the start. By 2009, after 12 years in the market, Domino's China had only 18 stores.

In late 2010, the franchise was acquired by Frank Krasovec, an American investor who today remains Chairman of DPC Dash. Investment increased, the pace of store openings picked up, and by 2017, DPC Dash had 100 stores. Nonetheless, performance was still not good, and some stores were lossmaking. This was due to a few major problems:

- Domino's business in China, like elsewhere in the world, was oriented toward delivery, for which it used dedicated riders; but the concept of ordering food delivery was not yet pervasive amongst Chinese consumers. The density of Chinese cities meant that there were many food options within walking distance, and people also frequently cooked at home. Pizza Hut, by contrast, adapted to this reality by orienting its stores to mainly serve in-store dining experiences, with a semi-premium Western restaurant feel (e.g., it served steaks and pastas).
- Under the influence of Bain Capital and the "capital-light" approach it developed for Domino's corporate (DPZ), which in turn was embedded into what DPZ's investors wanted from the company, DPZ was unwilling to invest its own equity capital to develop the China market, which left it with franchisee owners without enough resources to invest heavily through the years of losses needed to establish a foundation. This was again in contrast to what Yum Brands and McDonald's did to break through in the extremely difficult and competitive Chinese market – they largely built it with their own equity capital (Yum China was not spun off from Yum Brands until 2016, and McDonald's directly owned McDonald's China until 2017).
- Domino's was not localized well for the Chinese market, and was run by a series of non-Chinese CEOs that changed often.

- Domino's ran with outdated IT systems, manual processes, overstaffed stores, unincentivized employees, and so on – in short, it was still mismanaged.
- Poor results at store level and a scarcity of stores meant a lack of resources to invest in brand marketing, which led to low consumer awareness of the brand, which led to continued poor results that prevented substantial new store openings, and so on in a vicious cycle.

All of this changed when DPC Dash hired Aileen Wang as CEO in 2017. Aileen had eight years of experience at McDonald's China, and before that was a consultant at McKinsey in the US (she was also a *gaokao* champion, a top seven scorer from her hometown of Shanghai on the national college entrance exam). She quickly hired a team around her, with a large contingent coming from McDonald's China. The team made major changes to DPC Dash's operations, with some big help coming also from changes in China's broader consumption environment.

- The rise of delivery apps Meituan, Eleme, and Baidu Waimai in 2015 dramatically changed the role of food delivery in Chinese society. The huge rise of food delivery suddenly made Domino's business (>70% delivery) much more mainstream and viable. The necessity of food delivery during three years of covid, the consumer habits formed, and Domino's good performance in fulfilling orders to customers during that time, also built up its position and brand awareness.
- Various investors progressively injected more capital into the business, including $80 million from DPZ corporate (14% ownership today) in 2020-2021; DPC Dash is DPZ's only international franchisee investment, and a DPZ representative (currently Art D'Elia, EVP of International) sits on DPC Dash's board.
- Aileen and team applied the KFC/McDonald's/Pizza Hut playbook to localize the business and its menu. Menu items today include durian pizza, salted egg and chicken pizza, crayfish and chicken pizza, teriyaki flavored beef potato pizza, taro-infused crust, curry beef rice, lamb skewers, and pasta.
- Management completely changed out DPC Dash's outdated IT systems, many of which originally came from Taiwan; the company developed new systems for pizza delivery, employee scheduling, training, and ERP, each of which improved labor efficiency. Management processes, store standards, and store supervision also became much tighter, with frequent visits from top management, versus the very hands-off approach taken by previous management (the previous CEO before Aileen was a finance guy who didn't live in China while managing the business).
- Improving per-store economics created a virtuous cycle where stores could be opened at a faster rate, which further increased brand awareness of Domino's nationwide and in turn further improved store performance, which creates the opportunity for more store openings. This virtuous cycle of improved store economics driving more openings driving better economics is what we look for in restaurant investments, and it's interesting to be able to catch DPC Dash still relatively early in this cycle.

Current performance, store potential

Brand awareness of Domino's in China has now become so high that there is a frenzy whenever stores are opened in new cities: first-month sales blowing away Domino's global all-time records, <12 month store paybacks (<6 months at some stores), two-hour waits, high social media activity, new stores not even bothering to turn on delivery sales for months because they are overwhelmed with in-person orders, etc. New city results are so hot that one initial worry we had was whether there's a fad-like element in areas of current performance. Our research suggests that this is not the case, but rather that this is a clear positive sign, a reflection of pent-up demand in new cities for a strong brand and a very good-tasting pizza, a demand that was not being satisfied by existing options in the market. I also don't think this is a big risk for the longer term. We have years of steady results in Beijing/Shanghai where stores are much more saturated, new city sales slowly cool off over time but without precipitous drops, and pizza is a pretty well-established category with good price/value and enduring demand.

Customer feedback is that the pizza tastes very good, has better price/value versus Pizza Hut, and the delivery experience is superior. All deliveries are made with dedicated riders, mostly in-house employees, wearing Domino's uniforms; deliveries must be made under 30 minutes or else free food coupons are given; and the average delivery time from when the order is placed is 23 minutes, which is critical for pizza delivery to ensure taste, as most Chinese consumers don't have ovens at home.

Store economics are excellent. New store paybacks average three years in Beijing/Shanghai which are more saturated but still adding stores, two years in growth markets where there is already an established base of stores, and 6-12 months or less for first stores in new cities. Pizza is inherently cost-advantaged because the cost of material is just cheese and dough and a bit of protein, which means food and paper as a percentage of revenue can be kept in the mid-high 20s as opposed to low-mid 30s for most fast-food restaurants; furthermore, because Domino's focuses on delivery, stores can be kept very small and located in less-trafficked locations. The average Domino's China store costs only ~$200k in capex to build vs. ~$630k in sales and ~15% restaurant operating margin at maturity (after the 3% royalty paid to DPZ).

DPC Dash has 835 stores as of 3/31, a very low number for the China market. We can triangulate a number of data points here:

- 835 Domino's stores for a 1.4 billion population is <u>1.6 million people per store</u>. If we say the addressable market in China ("middle income" and above) is only 500 million, that still makes it 600k people per Domino's store, vs. 53k people per store in UK/Ireland, 35k in Australia/New Zealand, and 49k in the US.
    - Taiwan, with just 24 million people, has 189 Domino's stores, or 127k people per store.
    - Japan, with 125 million people, has 1,015 stores (123k people per store), and management has plans to take it to 2,000 (63k per store).
    - Korea, with 52 million people, has 481 stores (108k per store).
    - If we take a lower GDP per capita Asian market – Malaysia, which has $1k lower GDP per capita than China, has 34 million people and 260 Domino's stores, or 131k people per store.
    - Beijing and Shanghai combined is at 351 stores for 52 million people, or 149k people per store, and DPC Dash continues to see white space in these markets. I think Beijing and Shanghai may be able to get to <100k per store.
    - If China gets to 150k people per store for a 500 million addressable population, that would get to 3,333 stores. If we take a more aggressive framing and view the potential as 125k people per store for a 700 million addressable population, that gets to 5,600 stores.
        - The success of Domino's in India (1,928 stores), a country with per capita GDP only 1/5 of China's, and in particular its expansion to 407 cities within India, shows the potential of Domino's to adapt to even very low-income geographies.

- Pizza as a category is underpenetrated in China; including all players, there are 30 pizza stores per million people in Korea and Japan, 167 per million in Australia, and 232 in the US vs. <12 in China. So store penetration per capita of pizza in the US vs. China is literally a 20x, though of course there are huge cultural differences between the two markets. If China partially closes the gap to Korea and Japan and gets to 20 pizza stores per million people, that's an incremental 12,000 stores, to be spread amongst all the players.
- Pizza Hut has 3,425 stores in China, and is continuing to build them at a fast rate (+409 stores in 2023, and targeting ~4,600 by 2026). KFC has 10,603 stores in China and is adding >1,000 per year; KFC is at 45k people per store for the 500 million people it currently serves, which it expects to expand to 700 million by 2026. Pizza Hut is in 750 cities and KFC in 2,000 cities vs. just 30 cities currently for DPC Dash.
- Pizza players with lesser known or lower quality brands than Domino's see room for a lot of stores; Papa John's China, for example, has >300 stores and has committed with Papa John's corporate to open >1,350 new stores across just South China by 2040. Local player Champion Pizza (low price, but mediocre taste) has 2,500 stores.
- DPC Dash management is planning to open 240 stores in 2024, 300-350 in each of 2025 and 2026, and believes they can get to 2,000 stores by 2027, 3000 stores by 2029, 3500 stores by 2030, and >5,000 stores over the longer term.

Is competition a worry, given all the store openings planned by Pizza Hut, Papa John's, and local competitors such as Champion Pizza? We don't think so – DPC Dash's store economics and competitive advantages (brand, consistency, taste/value prop, delivery, cost structure) suggest that it should be able to more than hold its own and continue to get its fair share, with good store paybacks. No other player fully replicates the value proposition that Domino's brings to the Chinese consumer.

- Pizza Hut has too high of a focus on in-store dining (which detracts from an all-in focus on delivery, which is what the pizza market is moving to), inferior taste (e.g., Pizza Hut's dough is frozen, Domino's kept fresh and made with a consistent process in central kitchens), a large menu (only <40% of Pizza Hut's sales are actually from pizza; the rest is steak and other Western food items), and worse unit economics. In terms of corporate structure, within Yum China, Pizza Hut will always be a secondary focus vs. KFC; KFC generates 8x the operating profit of Pizza Hut and occupies the bulk of management's attention. Domino's by contrast is of course entirely focused on pizza.
    - Domino's has consistently beaten out Pizza Hut in other markets around the world (when Patrick Doyle became DPZ's CEO in 2010, Domino's was 2/3 the size of Pizza Hut globally, and he set out a goal to surpass Pizza Hut by 2020; this was reached in 2017, three years in advance). While some circumstances are different, others are similar (pure delivery competing against a hybrid delivery and in-store approach), and I believe a similar path will eventually play out in China.
- Champion Pizza is known for low prices but mediocre taste. Most of its stores are franchisees, which leads to worse quality control, and its strength and brand recognition is regional, mostly in southern China. It also purely relies on third-party aggregator delivery, which results in longer, more inconsistent delivery times and a worse customer experience. Our research suggests it's a different value proposition than Domino's.
- Finally, as mentioned earlier, China's pizza market is underpenetrated in general and growing fast, which should allow for multiple players to grow – potentially by >12,000 stores if not more, as discussed above.

DPZ management invested $80 million in DPC Dash, its only international franchisee investment, and has been saying very positive things about the company, its management team, and its growth potential that seem at odds with how DPC Dash is being priced today. DPZ of course has self-serving interest in saying these things to investors, as China anchors future store growth for the Domino's system, but the emphatic nature of these comments is interesting.

> On DPC Dash management:
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> "I was fortunate enough to serve as the DPZ representative on the Dash Board when we made that investment. That management team, as I've worked in the international business, pound-for-pound when you look at store count is one of the best that we have in the world when you think about operational execution and development discipline. **I'd put that leadership team against any we have in the world**." – Joseph Jordan, President of Domino's Pizza US and Global Services, 9/13/2023
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> On China store potential:
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> "I was actually just in Shanghai last week, and I can tell you, every time I visit this market, I come away even more energized and more confident about the future of Domino's in China. China and India combined over the next 5 years will deliver slightly less than half of our store growth." – Art D'Elia, EVP of International for Domino's Pizza Inc, 12/17/2023
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> "The growth that we can see coming in China is just **unbelievable and astronomical** in terms of relative to where we are, the potential growth is very, very strong **because the economics are very compelling**. And it's a highly developed QSR market where the demand for the Domino's brand is very high. So we continue to see a very strong appetite, not just in Tier 1, Tier 2 cities, but Tier 3 cities and wherever we're actually opening up stores. There's a lot of potential for us to continue to put down more and really apply the fortressing approach to drive much more density and much more growth in the China market with the size of potential stores that we haven't open yet being very significant relative to where we are right now." – Sandeep Reddy, CFO of Domino's Pizza Inc, 6/14/2023

Valuation

The valuation of DPC Dash today seems low and asymmetric. While we think DPC Dash can get to 4,000+ stores over time (so we assume an exit in YE2027 at ~2,040 stores, leaving substantial growth on the table which drives a decent exit multiple), we could be wrong on this front – but our downside is reasonably protected even if we're wrong.

Since DPC Dash is in only 30 cities today (vs. 750 cities for Pizza Hut and 2,000 for KFC) and showing very strong product-market fit in new city openings and densifications, we can reasonably say that 2024 and 2025 store openings are pretty locked in in terms of certainty, leaving DPC Dash with ~1,340 stores by YE2025. On 2025 numbers, DPC Dash today trades at ~10x EBITDA (adjusting the reported EBITDA to subtract IFRS 16 lease interest that otherwise falls below the line into finance cost, but should be included as an operating cost), which seems a low enough level as to provide downside support. Maybe DPC Dash de-rates to 8x and in the short-term we lose 20%. But EBITDA keeps growing at a high rate as we roll forward; on 2026 numbers, DPC Dash currently trades at just 7x EBITDA.

Store level unit economics are already very good (with room for another ~3 points of margin improvement from a combination of food cost scale, labor leverage, negotiating leverage on rent, and leverage across other lines like depreciation and advertising), but Adj. Net Profit is still quite low (2% in 2H23) because DPC Dash has invested heavily upfront in corporate functions in preparation for future store growth. Current profits are also impacted by accounting distortions such as a 1% drag from amortizing a one-time payment made to DPZ in 2017 (when DPC Dash's franchise expanded to cover all of China) that will not reoccur. The corporate-level investment will grow much slower than revenues and will leverage significantly over time (since we project that revenues will more than 3x from 2023 to 2028).

By 2028, we assume that DPC Dash generates a 6.0% Adj. Net Margin, still below the ~8% generated by Yum China. In our base case we assume that we exit in YE2027 at 21x NTM Adj. Net Profit (9x EBITDA), plus cash generated, which gets to a base case of ~23% IRR, with potential upside above that if the multiple expands beyond 21x to reflect a healthy, still-fast growing concept. Even if we get a poor multiple on exit (12x Adj. Net Profit, or 5x EBITDA), at the current valuation we still see a ~7% IRR. If excitement builds and we get a better exit multiple (say, 27x Adj. Net Profit or 12x EBITDA), we see an IRR in the 30s.

Stepping back a bit – DPC Dash trades for $850 million enterprise value today for what will likely be the #1 pizza brand in China. This seems too low.

Opportunity

Domino's is a well-known concept with lots of potentially interested investors; why are we the right ones to capture this opportunity?

I think a big part of the reason, in line with our overall thesis on low-liquidity stocks when we launched the fund, is that trading liquidity is very low. Despite a $1 billion market cap, DPC Dash trades <$1 million per day, a level that makes it uninvestable for almost all major funds (I feel like we've used this phrase a lot in our recent writeups). The company's past attempts to IPO were met with poor trading conditions, and when it finally decided to pull the trigger, no major shareholders wanted to sell; the company ended up doing 13 million shares of primary issuance, worth $95 million today.

There are few offshore funds scouring the HK market interested in stocks trading <$1 mm ADV. There is, however, more interest from mainland China in a company like DPC Dash, from local investors who can see the momentum in its business; trading volume picked up substantially in September 2023 when DPC Dash was included in the Shanghai-HK and Shenzhen-HK Stock Connect, and the stock had an immediate run-up from 50 to 70 HKD. However, on March 4th this year, DPC Dash was removed from the Stock Connect due to not meeting the requirements on trailing trading liquidity, which caused an immediate sell-off in its shares as some funds had mandates that required them to exit; the aftermath created the opportunity for us to buy our position. We believe, based on the Stock Connect's rules and how DPC Dash has traded recently, that this is temporary and it will eventually be re-included again, likely as early as September when the next Connect inclusion decision is made.

Liquidity should also continue to be released as small pre-IPO investors continue to exit; there are mostly rich American individuals who were brought on around when Frank Kravosec first acquired the franchise in 2010. The lock-up for pre-IPO investors that invested in 2020 and 2021 also expired on March 27, 2024.

Another reason for possible edge is because of investor fatigue with the HK-listed restaurant sector, as reopening in China disappointed expectations and consumer recovery was weak, leading to high promotional intensity in the sector. Jiumaojiu (sauerkraut fish) is down 77% from its 2023 highs, Haidilao (hot pot) -22%, Naixue (tea) -68%, and Yum China -37%. DPC Dash has performed very well through this environment, in contrast to the other companies, but is nonetheless down 23% from its late-summer highs. We have the advantage of picking this up with fresh eyes.

Investing in China

We are extremely cautious about investing in China, and the vast majority of our portfolio is allocated elsewhere. The Chinese consumer is suffering from the negative wealth effect of a property bust and as a result consumption recovery has been poor, with the government seemingly unwilling to stimulate; the political winds from within China are not encouraging, as the state has shifted to a focus on security over GDP growth; and geopolitical tensions are worsening, with likely more to come if Trump is elected. Furthermore, there is the age-old problem of business in China moving extremely fast and therefore being difficult to cover well from outside the country, even if we try to make frequent visits.

However, similar such thoughts among other investors have resulted in a bombed-out market for offshore-listed Chinese stocks, especially smaller, lower-liquidity ones that have effectively lost all coverage and interest. There is a price for every asset, and at times we may spot exceptional opportunities. Though multiples may be permanently lower than they were in the past, over the medium term stocks still follow business momentum; and, as it pertains to our strategy, we think China is a market that especially in new sectors disproportionately contains companies with obsessed entrepreneurs and great products, as those companies without great products and a will to survive die off quickly and in fact won't make it to stock market listing at all. We have learned many business lessons from studying the great Chinese entrepreneurs, and, whether we use those lessons in China or elsewhere in the world (prior deep work on Alipay and other Chinese online lenders, for example, helped us gain conviction in Kaspi), it remains a fascinating market to follow.

Chinese geopolitical risk cannot be totally avoided even by an exclusive investment focus on non-Chinese stocks, as China is deeply embedded into the sales mix or supply chains of many US and international companies. China risk is also inconsistently priced; American companies such as Tesla, Apple, Qualcomm, or even Walmart have major China exposure and risk, yet trade at high multiples, whereas many investors have completely sworn off looking at any Chinese companies, even if they, say, trade below net cash and have capital-returning management teams and good business positions. A discussion of the different categories of China risk (geopolitical, regulatory/political, management/capital return, etc.) can get nuanced, but in general we think the latter stance is too extreme and perpetuates inconsistent pricing for similar exposures/risks, which creates opportunity. A serious geopolitical event would impact us all. We don't go seeking for China risk if we see similar returns elsewhere, and are very mindful of our total exposure there, but we are willing to take on some heavily mispriced China risk vs. what we believe is an impossible task of avoiding it entirely.

As a side note: while we are willing to selectively invest in VIEs, it's important to note that like Yum China, DPC Dash is not a VIE. Fast food is not considered a sensitive category by the Chinese government, and full foreign ownership is allowed. DPC Dash directly owns its China subsidiaries. Cash can be readily moved from onshore to offshore at a 5% withholding tax rate.

Conclusion

Last week, HashiCorp announced it was being acquired by IBM; when the position reached an implied arb spread that seemed very reasonable given cost of funds and possible regulatory risk (as well as the low likelihood that our position will reach long-term tax treatment before the deal closes), we made the decision to exit. As is our usual practice, we don't immediately reinvest the proceeds into our existing portfolio, which was fully sized already based on our view of each position's risk/reward; instead, we hold it temporarily in cash as we actively look for new opportunities. Our cash balance is again high, as it was in mid-2023 (which then allowed us to invest counter-cyclically when stocks sold off significantly in October, including large purchases in HashiCorp and re-loads into Confluent and Money Forward). We have some interesting projects in the pipeline, and the recent market selloff, if it continues, will be helpful in that regard. Repeating a line I've used previously, which was paraphrasing Klarman – we don't need the entire market to be inexpensive to put significant money to work, just a limited number of great companies. We have no intention of holding a permanently high cash balance, and our past actions have shown that if the right opportunities arise, we can deploy it very quickly.

As always, I am immensely grateful for the opportunity to manage our capital and am hard at work trying to compound it at the highest rate that I can.

Yours,
Tim Liu

Appendix: Domino's Case Study, 2009-2016

Domino's (the parent company, DPZ) is itself a great case study for the power of product to drive business and investment outcomes.

In December 2009, DPZ's stock was down 61% from its 2007 dividend-adjusted peak, with part of the magnitude of decline due to high leverage at the company. The company had had four years of poor US same-store sales growth (2009 +1%, 2008 -5%, 2007 -2%, 2006 -4%), and its domestic store count was shrinking instead of growing.

Among other issues, it had one major problem: its pizza sucked. The Domino's system had the advantages of convenience, consistency, brand, and price, which were very important, but its pizza ranked last in blind taste tests, tied for last with Chuck E. Cheese (!).

In response, the company spent two years completely re-formulating its pizza. The company tested dozens of cheeses, 15 sauces, and 50 crust-seasoning blends over two years to arrive at its new recipe. It also paired its new recipe with a big marketing campaign, boldly admitting to how the previous pizza sucked and how the new one was much better. The new pizza launched on December 16, 2009 and rolled out to all US stores on December 27, with international markets following thereafter. Blind tests showed Domino's new pizza now coming out on top in the category, beating Pizza Hut, Little Caesars, and Papa John's each by a solid margin. The new pizza had a higher food cost, but the company felt it was worth the investment.

The financial response was immediate: in 2010, US same-store sales were +10% (Papa John's was -1% in the same year, McDonald's +4%, etc., so it wasn't just macro), followed by +4%, +3%, and +5% in 2011, 2012, and 2013 respectively. Alongside the new pizza, management also made good strides in reimaging stores, retraining franchisees, and weeding out bad franchisees to ensure consistency.

The company's focus on product continued with its other big initiative: technology, specifically digital ordering. Domino's pizza tracker had rolled out in 2008, Domino's mobile app launched in 2011 with immediate traction, and Domino's continued to put a lot of investment into digital ordering. Digital sales in the US went from 25% of revenue in 2011 to 60% in 2016. Digital ordering drove higher customer satisfaction and more frequency and retention, and gave Domino's a weapon to beat back independents/regional chains, which for a while had maintained stable share vs. the big franchise systems until around 2010. The convenience to the customer of a reliable, easy digital ordering experience – in theory a very simple concept – proved key. The string of great US same-store sales continued: 2014 +8%, 2015 +12%, 2016 +11%, etc. With improved franchisee unit economics (key to studying a franchise business), domestic store growth was able to resume as well, and international store growth accelerated from an already-high pace.

From December 2009 before the new pizza launch to December 2016 (picking an arbitrary end date; the stock continued to rise strongly after 2016), DPZ stock rose 24x with dividends invested, an annual CAGR of 56% (!). Many factors contributed to this absurd return, including significant financial leverage at the start and growth in international stores. I love to decompose case study returns into its various factors; what's fascinating here is that out of the 56% total annual return, gross profit (a substitute for revenue given the dynamics of company-owned vs. franchised stores) only CAGR'd at 10% and operating profit at 13% (as high-margin franchise fees flowed through). A lot of heavy lifting came from leveraging and refinancing interest expense, which contributed 9% to the total CAGR to bring Net Income CAGR to 23%. Diluted shares outstanding declined at a 2% annual rate due to buybacks, and reinvested dividend yield contributed ~1 point. One more big source of return that when added on top made the return truly incredible was multiple expansion; the LTM P/E multiple expanded from 9x to 37x, a 22% CAGR, as the perception of the company changed from an over-levered, unhealthy franchise system to that of a healthy, growing one.

This case study shows that a lot of financial factors beyond pure product contributed to the total return, and it's of course important to include them in our analysis of investments, as well as think creatively about how certain investments can benefit from the compounding of multiple factors. But with Domino's, it all started with an improved pizza and an intense focus on the customer ordering experience.

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