February 2nd, 2024

Dear Partners,

In January I traveled to Kazakhstan and Georgia, in order to see for myself the products that we are investing in. It was a great trip. We can and do talk to management teams and industry experts repeatedly over Zoom, but it doesn't match the full immersion of a visit and the added value of meeting with people face-to-face. And of course, I got to see the products in action. Some of the most interesting moments of the trip were just the time I spent loitering around checkout counters at various stores in Almaty and surreptitiously watching how people paid for purchases (answer: the majority with Kaspi). After watching for a while at each place, the translator and I would then go up to the merchant and bombard them with questions about Kaspi.

I of course don't claim to be an expert in these countries after one visit. But nor do I believe it's impossible or unwise to invest in the region if we're not locals. Compared to bigger markets like China and the US, business trends in these small Central Asian/Caucasus countries move slower, competition tends to be quite weak, and we've found companies in dominant market share positions. Plus, single digit million daily trading liquidity means that there's no pod money or big funds in these ideas. If we pick a competitively dominant, well-managed company with a clear growth path and a very low valuation, we have a good chance of making money, and our experience so far has shown this to be the case.

Why are we investing in Kazakhstan or Georgia at all? The answer sounds trite, but is truly how we look at it: risk-adjusted IRR relative to alternatives. We use the global opportunity set available to us (which is larger than that for larger funds, since we specialize in lower-liquidity stocks) to shift our capital toward areas with the highest risk-adjusted returns and away from areas with momentarily low risk-adjusted returns, in line with our stated goal of maximizing returns while minimizing portfolio drawdowns. In a perfect world, we might have 100% of our portfolio in US SaaS, which has some of the strongest moat/growth combinations we've ever seen and correspondingly produced some of our biggest winners, but that sector is volatile and valuations frequently run away from us (and on the flip side, pod-driven crowding frequently leads to major blowups as well, which present great opportunities for us to enter). Rather than chase when valuations look to be at highs and potential returns at lows, we sift through the rest of the world looking for the best places to put our capital. If we find a company in, say, Kazakhstan that has an amazing product, a great management team, high growth, and a very low multiple, then that's worth taking a look.

Geopolitical risks, regulatory risks, governance risks, currency risks, and various other emerging market risks do give us pause, as they should – but we study each situation's idiosyncrasies, research and think through risk cases, and ultimately judge risk/reward, as is our job. And in the process, I've developed an admiration and respect for how the economies of Kazakhstan and Georgia have developed and digitized (in our Q2 2023 letter, I wrote about Georgia's enormous turnaround after 2003's Rose Revolution), as well as an awareness of how they are easily stereotyped and misunderstood (it's easy to make generalizing comments like, "Kazakhstan is close to Russia, there's huge geopolitical risk there" or "wasn't/isn't Georgia going to be invaded by Russia?", etc., when in fact the reality is nuanced and we judge the risks to be much lower than they might appear on the surface. We discuss the risk from spillover of Russian sanctions later in this letter).

Kaspi

Kaspi is the Alipay of Kazakhstan. It's a super-app that has a combination of payments (via QR code), lending (BNPL and cash loans), ecommerce (in the home page of the app right below the payments section), government services (for example, a legally-recognized driver's license can be pulled up from the app), grocery, classifieds, travel, etc.

Usage of Kaspi is ubiquitous. The reported usage metrics (2.3 transactions per user per day) are so high that it really has to be seen to be believed. On my visit to Almaty, I saw Kaspi used everywhere. Every merchant we visited accepted Kaspi, most often with a Kaspi POS device (that Kaspi has smartly blanketed the country with), which generates a QR code that users scan with their Kaspi app in order to pay. The smallest informal merchant selling Korean pickled vegetables at a stand down to the busker on the street would display their Kaspi QR code on a piece of paper. Even the Almaty Central Mosque, the largest in the city, prominently posted its Kaspi QR code at numerous places on the mosque's exterior, implicitly encouraging worshippers to donate via that method.

User feedback on Kaspi was extremely positive. Users didn't just like Kaspi, they loved it. They praised its convenience and were proud that their country had leapt forward technologically with such a service. In addition to the payments itself, users gave very positive feedback about Kaspi's BNPL, travel, and ecommerce functions – validating management's comments about each of those areas.

Kaspi makes money from a familiar pattern we've seen with other fintechs from around the world: 1) Payments; 2) Lending; and 3) Ecommerce. Dominating in daily payments leads to opportunities to push lending, with huge advantages in data that drive better underwriting vs. competitors; and the frequency of opening the app for payments and the ease of borrowing in turn drive natural advantages in ecommerce, which can be placed prominently in the app's home screen. Kaspi's profits are split into 36% Payments, 36% Lending, and 28% Marketplace (which includes ecommerce and also the merchant fee from BNPL).

Kazakhstan's weak competitive environment means Kaspi can use its advantages to fully capture and monetize each major area, instead of being forced to make tradeoffs like using payments as a loss leader for lending (like for Alipay in China, due to intense competition with WeChat) or being blocked from entering into ecommerce by established incumbents (like in the US, Brazil, or Southeast Asia).

In payments, Kaspi charges merchants 0.95% for its QR code transactions (P2P transfers between users are free). This is both a huge profit center for Kaspi itself (the revenue comes with very few costs, as it bypasses the card networks as well as other banks), as well as being a good deal for merchants, who would otherwise pay ~3% to accept credit cards. Additionally, users holding money in transaction accounts in anticipation of immediate use on Kaspi don't receive interest on those accounts, which gives Kaspi the opportunity to earn ~15% (the current Kazakh central bank rate, which is at a cyclical high and will likely come back down to 10-11% as inflation continues to moderate) for itself on those balances.

In lending, Kaspi monetizes in several forms. First, in BNPL, a substantial portion of the economics comes from the merchant. Kaspi charges merchants ~8% to accept BNPL, which is free for the consumer if the loan is fully paid off within three months. One of the key research questions we had was around the sustainability of this take rate, which is higher than in developed markets (in the US, for example, Affirm charges ~3% above the regular merchant discount rate). Our research was conclusive that this higher rate is indeed sustainable in Kazakhstan: 1) Kaspi is lending for a longer period (standard 3+ months vs. 6-8 weeks for Affirm), in a much higher interest rate environment (15% vs. 5%), which necessitates a higher upfront take rate; 2) multiple sources told us that Kazakhs uniquely love the payment deferral aspect of BNPL, perhaps to a greater extent than anywhere else in the world other than maybe Brazil, such that without Kaspi BNPL a merchant's sales would fall 20-30%, and with corresponding sales bumps on the other side when BNPL is first added; 3) merchants we spoke to understood these dynamics and generally were satisfied with their results vs. costs from Kaspi BNPL; and 4) there is very little competition to pressure these BNPL rates. Due to a combination of technical barriers and management inertia, no competitor has been able to create a BNPL product that's nearly as seamless as Kaspi's. Halyk Bank, the

#1 bank in the country that has an overall loan book 2.4x Kaspi's size (but is now smaller than Kaspi in retail loans), has a BNPL portfolio that is a small fraction of Kaspi's size, a confused jumble of difficult-to-use BNPL products that it is still restructuring, and seemingly limited ambition to compete much more aggressively in BNPL. Though growth will inevitably slow as the product is maturing and merchant rollout has slowed, in the latest quarter Kaspi's BNPL volume (what the company calls "m-Commerce GMV") grew 47% y/y.

Kaspi's interest-bearing loan portfolio consists of BNPL borrowed for a period longer than three months, general unsecured cash loans, and a fast-growing business of SMB merchant loans. Including fees, Kaspi generates an average yield of ~35-40% on these loans (Kaspi reports an average yield of 26% on its portfolio, but that includes a drag from the standard 3-month BNPL which is interest-free. 35-40% may seem high, but the implied NIM is not out of line with that of other EM lending fintechs, and in fact is substantially less than what for example Nubank charges on interest-bearing credit card loans), which it fully funds using customer deposits that pay market interest rates. This is a great business on its own. Kaspi's combination of 1) superior data from its visibility into transactions and 2) superior technical talent allows for much better underwriting vs. peers. Cost of risk for Kaspi, defined as total provision expense divided by average balance of loans, is <2%, which is in a similar range to that of large universal banks in Kazakhstan, despite nearly all of Kaspi's lending being unsecured and to retail clients.

Finally, as mentioned above, Kaspi is using its advantages to expand into ecommerce. Ecommerce is relatively new in Kazakhstan, with penetration at only ~12% of retail sales, driven largely by Kaspi which has ~65% market share (pre-covid, ecommerce was at only ~2% penetration of retail sales in the country). Kaspi is rapidly expanding its assortment (with 4.5 million listed SKUs today vs. 1.5 million at the end of 2021) and delivery infrastructure (including for example 6,000 Postomat pick-up lockers today, comprising 37% of deliveries, vs. 327 lockers at the end of 2021). ~89% of Kaspi ecommerce orders are delivered free for the consumer, and ~45% of orders are delivered within 24 hours.

Of all of Kaspi's businesses, ecommerce faces the most competition. Local marketplaces are not much of a threat, but specifically the Russian players, Ozon and Wildberries, have entered the market and are investing aggressively. The likelihood of their success vs. Kaspi is a topic we are still studying. Kaspi has major advantages, including its entrance point in an app used daily and its huge power to lend against purchases (very important in Kazakhstan, as described above), but we've heard that the Russian players are more sophisticated at logistics and investing in a warehousing-heavy model, and we're following closely to see how Kaspi executes on its own logistics development, which for now is pursuing a capital-light model. In our base case, we assume Kaspi's market share falls from ~65% to the mid-50s as the market naturally evolves and grows, but even in a much worse scenario, the threat is not existential as ecommerce only accounts for ~8% of Kaspi's revenue today.

We've mentioned it above a couple of times, but it's worth reiterating how the weak competitive market makes Kaspi a better business. Technical talent and strong management talent are not abundant in Kazakhstan. Everyone we asked named Kaspi as the #1 technical team in Kazakhstan, some named Halyk Bank as the #2, but the list really fell off after that. And Halyk, despite having the resources to hire good engineers, is run like a SOE, with slow decision-making and a seeming inability to push through beautiful products to completion. Competitors seemingly cannot create products as seamless to use as Kaspi's, and as a result Kaspi is running away with the retail market; in 3Q23, Kaspi grew retail loans at 33% y/y vs. Halyk at 21%, and Kaspi grew retail deposits at 42% (!) vs. Halyk at 9%, due to the convenience of having deposits at Kaspi to use in QR payments. As one indication, during my visit I saw several places where there would be a line of ~5-6 ATM machines, one from each bank, and the Kaspi machine would have a line behind it and all the others had no customers. Speaking to management and employees at competitors, I get the clear sense that they are playing to not lose rather than to win.

Management quality and business quality are not absolutes, but must be judged against the relative competition that the company faces. Taking China as an extreme example – the *average* Nasdaq-listed Chinese tech company I've studied is fast-moving, has lots of talented engineers, is efficient on costs, has a very good product (otherwise, it would never have survived the culling process to receive rounds of VC funding and get listed in the first place), and smart, strategic-thinking founder-led management – in other words, what would otherwise be a combination for a great company. But the very nature of operating in China may make it an average or bad business, because its competition has the same qualities and may in fact be even more extreme! The opposite situation in Kazakhstan must be taken into account when evaluating the quality and durability of Kaspi's business.

Growth, Valuation

One common pushback to Kaspi is to point out that Kazakhstan's GDP is ~$260 billion, Kaspi's market cap is $18 billion, and thus the seeming improbability of a company worth 7% of its country's GDP to be a huge compounder from that level.

This is a helpful sanity check, but clearly, comparing a stock vs. flow variable at macroeconomic scale should not be the ending point for analysis. Kaspi is unusually dominant in Kazakhstan tech, covers as a result an unusually large swathe of the economy, and is unusually profitable with a 45% adj. net margin, such that in 2023, Kaspi generated ~$1.9 billion of adj. net income, which makes the market cap only 9x trailing earnings (and 8x our estimate of 2024 earnings). If the stock traded for 20x forward earnings, then valid questions would be raised about whether enough growth remains in Kazakhstan for Kaspi to capture to justify its stock price, but it trades at just 40% of that.

We know these earnings are "real" in part because Kaspi consistently pays out, on a quarterly basis, ~75-80% of adj. net income via dividends and buybacks. And as Kaspi is a systemically important financial institution, its data is fed into and closely monitored by the National Bank of Kazakhstan. Its banking competitors treat it with deep respect, whereas if they noticed any discrepancies, it would long ago have been in their self-interest to point them out and report on it. We've spoken with numerous former employees about the company's culture, its business, and management's character. Kaspi is not an overnight sensation, but rather the result of 17 years of steady business-building, product by product, to reach where it is today.

Kaspi's business in Kazakhstan inevitably will slow from the ~48% y/y revenue growth in 2023. We've seen from the Alipay/WeChat Pay examples in China how a QR-based payments business can go from fast growth to suddenly hitting a wall once full penetration is reached. We think there's ~1 year of growth left in payments before Kaspi reaches that point. The runway is longer in lending, where Kazakhstan's consumer loans to GDP percentage is still lower than in peer countries and only 40% of Kaspi's users have tried its BNPL, and even longer in ecommerce, which as a sector is underpenetrated at just 12% of retail sales. Overall, we project teens growth above inflation in 2024 and 2025 before slowing to single-digit growth above inflation in 2026 and beyond. In our model we assume no international expansion (discussed below). But despite these arguably conservative assumptions, we see a >30% IRR in USD for Kaspi stock, driven by its earnings growth, an unreasonably low starting multiple (8x 2024 earnings, which we assume re-rates to 10-11x), and its high cash return yield. Our assumption for currency is that the Kazakh tenge depreciates vs. the USD at a 6% annual rate, slightly better than its long-term historical average (Kazakhstan experienced a huge shock from the oil price crash in 2015, and its currency depreciated 46% that year) but in line with anticipated inflation/interest rate differentials vs. USD.

Kaspi has been clear that they intend to expand beyond Kazakhstan and over the long term profitably serve 100 million users vs. the 14 million they serve today. We admire this ambition, and we're confident that whatever move this management team ends up making will be value-creating rather than value-destructive. We give this international opportunity no value in our base case because of uncertainty – even Kaspi's management has not yet decided on which market it intends to enter (possible candidates include Uzbekistan, Azerbaijan, and certain countries in Eastern Europe), and each possible new country we've studied in the region will come with its own challenges. Furthermore, the sheer scale of Kaspi's $1.9 billion of profits in Kazakhstan will make it difficult for any other market to move the needle, at least in the short to medium term.

Kaspi's New York IPO in late January comes after three years of being listed in London. The London listing suffered from very low liquidity, as unfortunately seems to be typical for London stocks. Despite a $18 billion market cap and a $4 billion float, Kaspi only traded an average of $3 million per day, a level that excludes most funds that might otherwise be interested in such a fast-growing and profitable tech company (our estimate is that $3 million daily liquidity is only investable for funds with a maximum of $200 million AUM, based on an assumed requirement of 15 days to exit at 20% of daily volume). The New York listing added another $1 billion in float (founders Kim and Lomtadze and PE backer Baring Vostok each sold shares, with no primary issuance by the company), and the previous London float is now also fully tradeable in New York. Meaningful early trading in the first few days is likely not representative, but our hope is that with New York's much higher volume for the average stock (as measured by daily liquidity as a percentage of float), daily liquidity can get to $10-15 million, a 3-5x increase that can draw in funds of up to $1 billion in size.

Background, Management

Kaspi was founded by Vyacheslav Kim in 2002, but it remained a sleepy bank until Mikhail Lomtadze, Kaspi's current CEO, joined in 2007 at age 31. Lomtadze, a Georgian who graduated from HBS in 2002, was then a partner at PE firm Baring Vostok, and he convinced Baring Vostok to invest for 50% of the company after meeting Kim.

Lomtadze's vision was to shift the bank away from corporate/SME lending (95% of the business at the time) toward a focus on retail banking. Lomtadze saw that there was no competitive advantage in the corporate business, but that one could be built in the retail business, which was a technology game.

After a few early years focused on making the pivot to retail and making the bank profitable, Lomtadze became focused on the customer, studied Amazon and Google as inspirations, and in 2012 picked NPS as the top KPI for the organization – which was music to our ears as product-focused investors, when we read this in a 2019 HBS case study on Kaspi.

The rest is history – Kaspi came out with product after quality product that steadily grew its user base and value proposition: online bill pay in 2012, a marketplace in 2014, Kaspi Red BNPL in 2016, P2P transfers by phone number in 2017, QR payments via POS in 2019 (which then exploded across the country in volume over the course of just one year), Kaspi Travel in 2020, Kaspi Postomat and B2B Payments and e-Grocery in 2021, etc.

Former employees describe Lomtadze as a driven leader who demands and gets results out of his team. He's young, age 48, and owns 23% of the company, a stake valued at $4 billion.

Kaspi maintains good relationships with Kazakhstan's government, which sees it as a technology champion and a source of pride for the country. Kaspi's main banking competitor Halyk Bank, in comparison, is a legacy bank that is 70% owned by the daughter and son-in-law of the former longtime president Nazarbayev, whose relatives and close associates are under pressure from President Tokayev's efforts to reduce Nazarbayev's influence (to date, however, no actions have been taken against Halyk Bank, and Tokayev's anticorruption efforts have focused on individuals rather than companies).

Shortly after Kaspi's New York IPO in January, President Tokayev met again with Kim and Lomtadze. Kazakh media reported the following:

> "During the meeting, the President was informed about the results of the work and prospects for the development of Kaspi.kz.
>
> Vyacheslav Kim and Mikhail Lomtadze briefed Tokayev about the Kaspi.kz's successful IPO on NASDAQ in the US. The Kazakh Head of State congratulated the Kaspi.kz. co-founders on this achievement.
>
> The President also discussed with Vyacheslav Kim and Mikhail Lomtadze the prospects for improving the investment climate to attract more leading world investors in the country."

The last line of the readout from the meeting matches a major theme that has been present in Tokayev's speeches and actions, which is to increase foreign investment in the country, and to do so by providing a good climate for foreign investors. Specifically in the public markets, there are four Kazakh companies listed on major international exchanges: Kaspi, Halyk Bank, Kazatomprom, and Freedom Holding. Excluding Freedom Holding, which is quite a suspicious company that was originally founded in Russia and listed in the US via a reverse merger, the three other Kazakh companies (we've met with all three repeatedly) pay out a high percentage of their earnings to shareholders (Kaspi 75-80%, Halyk 50%, Kazatomprom 75%+), hold frequent investor calls and events, and take their obligations to shareholders seriously. Our understanding is that the Kazakh state, in addition to wanting to attract more foreign investment, hopes to use the success of its foreign listed companies to IPO more of its state-owned portfolio in the future.

Is Kazakhstan at risk from Russia-linked sanctions?

Since Russia's invasion of Ukraine in early 2022, Kazakh publicly traded equities have received a large geopolitical discount, due to the perception of Kazakhstan's closeness with Russia and the associated sanctions or other risk therein.

Since the invasion of Ukraine, however, President Tokayev has been firm in rejecting any participation in Russia's invasion and abiding by all international sanctions. In a public forum after the invasion when they shared the stage, Tokayev directly stated to Putin that he did not recognize the territories of Luhansk and Donetsk and that Kazakhstan upheld the inviolability of internationally recognized borders. Kazakhstan has not supported Russia in votes in the UN General Assembly. A member of parliament, Azamat Abildayev, was kicked out of parliament for stating that he supports the "special military operation" in Ukraine, and Russian artists openly supporting the war have been barred from performing in the country. Kazakhstan has passed laws tracking the movement of goods from border to border in order to comply with Western sanctions and bans on export of war-related goods, and as an example of the result of sanctions in banking, Sberbank Kazakhstan and Alfa-Bank Kazakhstan were sold to Kazakh banks.

For the purposes of investing in the country, we believe the risk of secondary sanctions to be low, as Kazakhstan's government seems to be fully focused on avoiding such sanctions. As a former Soviet Union country that shares a long border with Russia, Kazakhstan inevitably has major economic and cultural linkages with Russia (13% of Kazakhstan's exports and 38% of its imports are with Russia). But the country clearly sees pursuing its "multi-vector foreign policy" to be its main interest, to leverage the Russia/China/EU/US powers that each have an interest to not have Kazakhstan fall too much into any one camp, and we expect the environment to be stable.

Conclusion

As markets have continued to rally, our cash balance has steadily crept up, and we have been shifting appreciated US exposure to higher-return investments overseas. We again have a lot of capacity to deploy into weak markets, if they come. But waiting for weak markets is not our goal; our goal is to deploy today as much of our capital as we can into sufficiently high-return opportunities, and we are hard at work continuing to look for them.

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

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