July 1, 2018

2018 Interim Shareholder Letter

Wiedower Capital gained 2.72% (net of fees) in the first six months of 2018. Appendix 2 has our full historical results.

Wiedower Capital is focused on the highest-quality companies and CEOs that have industry tailwinds behind them and long runways for growth ahead of them. Research is focused on how an industry may evolve over the next 5-10+ years and if a company's competitive advantage can expand within that evolution. Qualitative factors are emphasized over quantitative, and the portfolio is concentrated with long holding periods. See Appendix 1 for a summary of Wiedower Capital's investment philosophy.

In my 2017 annual shareholder letter, I described our portfolio companies as falling into two distinct buckets. The first bucket, what I called our core investments, was described as very high-quality companies that I think can compound their value for the next 10+ years. The second bucket was described as above average companies that are simply too cheap. My sole focus is now on finding those first bucket, compounder-type companies. This transition to focus exclusively on compounders is a result of me realizing that a portfolio of long-term holdings fits my personality better.

One of the things I'm most passionate about is entrepreneurship. I've started a couple companies myself and am currently the Finance Chair for the Austin chapter of Entrepreneurs' Organization. I always love meeting other entrepreneurs and learning what unique things they are building. As it relates to investing, I've realized over time that I get more excited about founder-led companies than those that are run by hired CEOs. There are exceptions of course, but more often than not the types of businesses I enjoy researching are run by passionate founders with mission-driven cultures. As I discussed in my last shareholder letter, I don't get nearly as much intellectual stimulation from investing in companies that don't have a unique long-term vision. And the more I enjoy following a company, the more effort I put into keeping up with it.

I've also come to accept that I don't enjoy the actual process of buying and selling stocks. I don't like checking stock prices and volume, placing orders, and keeping up with trades. Hell, I don't even like opening Interactive Brokers. Sometimes I go weeks without logging into Interactive Brokers and that's perfectly fine by me. Buying and selling positions is a major mental distraction and it takes me away from what I enjoy most—researching and learning. I enjoy holding investments a lot more than I like buying or selling them. Thus, a concentrated portfolio of companies that we can own for many years is more my style.

Finally, having a portfolio of long-term positions results in less pressure for action. If we own ten stocks with an average holding period of 1-2 years, I have to find a new company to invest in every 1-3 months on average. That's basically non-stop pressure to find new investments—and I've struggled with that pressure before.

When I launched Wiedower Capital in early 2015 I only had a few good investment ideas, so our cash position was over 50% for several months. I didn't like having that large of a cash position and it resulted in me making several poor decisions that badly hurt our 2015 results (and bled into 2016 as well).

Alternatively, if we own ten stocks and the average holding period is between five and ten years, now I only have to find one new investment every 6-12 months on average. Finding a new company to invest in every 6-12 months as opposed to every 1-3 months is a significant decrease in pressure. I hope that having less pressure to find new companies results in higher quality investments when they are made.

As much pressure as I felt back in 2015 to make investments, I feel the complete opposite now. I like every company we own. Some of them are fairly valued, some are still cheap, but I have no reason to sell any of them. Unlike many investors, I generally don't sell a position just because it reaches my estimate of fair value. Even with the few positions we own that I think are fairly valued, I still expect them to match or slightly beat the market going forward (maybe 7-12% expected returns per year or thereabouts). So, if I sell a fairly valued stock just to sit in cash, I'm costing us an expected 7-12% per year on that position size. Ideally, I would only sell a position when I am replacing it with a new company that I like significantly better. Thus, for me to sell one of our positions (which results in taxes) and replace it with a new company (that I don't know as well), I have to be very confident in the expected returns being better than 7-12%.

Acquisitions

Two of our previous holdings, Elbit Vision Systems and Fogo de Chao, were acquired in February. At the time, they were our two smallest positions at around 5-6% each. They both had been struggling the past couple quarters, so I never increased our sizing after they drifted down. I much prefer to average up as a company performs well as opposed to average down as a company struggles.

In total, the Elbit Vision Systems and Fogo de Chao acquisitions added 1.8% to our returns for the first six months of 2018. I consider this return to be pure luck and non-recurring. Going forward, I expect and hope that we have very few portfolio companies acquired. When I buy a new position, I am going in with the mindset of owning it forever (while recognizing that won't happen very often). An acquisition may give us a nice one-time gain, but it leaves us sitting in cash and unable to benefit from many years of compounding.

New position: JD.com

JD.com is the third largest e-commerce website in China. What makes JD unique is that they own their entire end-to-end logistics network. They buy product from manufacturers, store it in their own warehouses, sell direct to consumers, and even manage the last-mile delivery to the customer's door. JD's largest competitors, Tmall and Taobao, are both marketplaces that connect buyers and sellers. Tmall and Taobao don't buy their own inventory or ship it direct to consumers—they are more similar in concept to eBay. JD is more akin to Amazon.

If you're thinking "How in the hell can Travis have an edge investing in $60 billion-dollar Chinese companies?", I don't blame you. It's not something I take lightly. In some ways, JD is a step outside my normal investing circle (smaller domestic companies), but in many ways, JD is very similar to our core holdings. As I've talked about before, my favorite investments have the following characteristics:

- Founder-led (high insider ownership)
- Durable competitive advantage
- Industry tailwinds at their back
- Long runway for growth
- Profitable
- Safe balance sheet (lots of cash, little debt)

Of the compounders that we currently own, each one has at least five of those characteristics, and JD has all six. On the other hand, JD is several hundred times bigger than most companies I look at, and it's based in a Communist country that I've never stepped foot in. While nothing I do can ever replace the comfort I would have from growing up in China and experiencing their culture on a daily basis, I have put a lot of effort into learning as much as I can—from reading several books covering everything from China's history to Richard Liu's biography (he's the founder of JD), to getting access to third-party research firms that focus on Chinese consumer data, and finally talking to people who live in China.

For as big of a company as JD is, I was surprised to come to the conclusion that it appears to be meaningfully undervalued. In general, I find small and micro-cap companies are mispriced more often than larger-caps. This is why I focused exclusively on smaller companies when I launched Wiedower Capital, but my thinking has evolved. I've come to realize that I care more about high-quality companies and CEOs with long runways for growth than I do the initial size of the company. Even a company as large as Amazon can have a very long runway for growth. Back to JD, I think there are two factors at play that lead to its undervaluation.

First, like many of our investments, is the time horizon that I look at JD through compared to the vast majority of Wall Street. Most investors care what JD's earnings will be next quarter and next year, while I care about whether their competitive advantage can survive the next couple decades. I don't care what their earnings per share will be in 2018 because it matters very little to the intrinsic value of JD.

Second, people who live in China currently can't invest in JD (or any of the large Chinese tech companies that are listed in the US). But this is about to change. Imagine if Amazon was only listed as a public company in China (where they barely do any business) and Americans weren't allowed to invest in it. I bet Amazon's stock would be a lot cheaper because the people who use Amazon and understand it the most can't invest in it. That's the situation that JD is currently in.

When I'm researching a company, my goal is to identify the handful of key factors that will determine a company's long-term success or failure. It's impossible to know everything about an investment, but if I'm right about the main drivers of the company and industry, I'll probably be right about the general direction of the investment. With JD, the four key drivers I focused my research around were: China's tailwinds as a growing consumer economy, if I can trust Richard Liu (the founder/CEO), how durable JD's competitive advantage is against Tmall and Taobao, and the risk of government intervention and regulations.

China tailwinds

One of the most important questions I ask myself about potential investments is: "Are the world's trends in front of or behind this company?" I want to invest in companies that are being pushed forward by the biggest and most inevitable tailwinds in the world. And one of the largest trends the past twenty years has been China's exploding middle class. Just in the ten years from 2008 to 2017, China's average yearly wage went from 29,229 yuan to 74,318 (for a compounded annual growth rate of 9.8%). More importantly, this increasing wealth is expected to continue.

The Chinese government has said that expanding the middle class and increasing consumption are two of its major goals going forward. Historically, China has had one of the highest savings rates in the world, but after peaking around 2010, household savings rates have been coming down. As the Chinese get wealthier, their consumption rates increase. And within that trend, people under thirty are not as frugal as the older generations who grew up in a very different economy. Consumption by the younger generation is growing 1.5x faster than the overall population.

In addition, internet penetration rates still have room for growth. In 2017, internet penetration in China was 56% vs the US at around 80% (and several European countries over 90%). Within this, 38% of the Chinese population shopped online in 2017 compared to 67% of the American population. Even the 38% of the population who already shops online will almost certainly increase their rate of purchasing going forward. As people get more comfortable with the internet and come to trust online shopping, their purchases go up over time. In summary, the major tailwinds benefitting JD are that the Chinese are getting wealthier, their consumption rates are increasing, and they are using the Internet more.

Trusting Richard Liu

Richard Liu started JD in 1998 at a market stall selling small electronics and has grown it into one of the largest retailers in the world. While I've never spoken to Liu, it's still important for me to get comfortable that he is someone I can trust with our money. I've read as much about Liu as I can, through many news stories, interviews, his biography, and obviously what he's done at JD. Through this research, there are three common threads that have really stuck out to me.

First, he is obsessed with low prices. He is well read on Sam Walton and Jeff Bezos and he mentions them on a regular basis. Liu understands that low prices win retail and the only way to continually drive prices lower over time is to have more scale than the competition. Low prices win retail and thus scale wins retail. Liu has made it very clear that low prices are not a temporary tactic—his long-term goal is net margins of 3-5%.

Second, he is obsessed with authenticity, which I think is important in a country that is getting wealthier but is also known for its cheap knock-offs. Authenticity is clearly a core belief of his. A quote from Liu: "Any true company of the people would not sell fake products to its own people."

Finally, Liu has zero tolerance for corruption of any kind. He has fired employees for accepting meals from manufacturer reps and he has stopped working with manufacturers for even attempting to give JD kickbacks. From what I can tell, JD pays well and treats employees well, but they are also very strict. Even minor transgressions result in being fired and reported to the police. A quote from Liu: "It is not that I am merciless, it is that what you've done is completely contrary to my values and has subverted my dreams... I cannot tolerate corruption in my life. I won't accept it and nor shall you."

JD's competitive position

JD's two largest competitors, Tmall and Taobao, are both owned by Alibaba. Taobao is the market leader, Tmall is second, JD is third, and then there is a large gap between JD and the smaller players. It's hard to get exact market share numbers because of how the companies report gross merchandise value, but my best estimate is Taobao's share of the online retail goods market is in the low-30s, Tmall is in the mid-20s, and JD is in the mid-teens.

Both Tmall and Taobao are marketplaces that connect buyers and sellers—neither owns inventory or their own logistics network. Taobao is a consumer-to-consumer (C2C) marketplace—it connects individuals selling to other individuals. Tmall is a business-to-consumer (B2C) marketplace—it connects businesses selling to individuals.

Tmall is more of a direct competitor to JD than Taobao is. Tmall focuses on higher-quality goods from established brands, while Taobao is filled with cheap products that are low quality and/or counterfeit. While Taobao has historically dominated Chinese e-commerce, there has been a shift in preference the past few years for the higher-quality and reliability that comes from the B2C segment. Taobao has been losing meaningful market share the past three years while JD and Tmall have both been gaining share (JD more so than Tmall, but JD is also coming off a smaller base).

To be clear, I don't expect the Chinese e-commerce market to ever be dominated by one player like the US market is. The US and China e-commerce markets developed much differently, and I think Taobao, Tmall, and JD are all too established at this point to not survive for the long-term. However, I do think JD can continue to grow their market share as they have the past three years.

The biggest difference between JD and Tmall and Taobao is that JD controls the customer experience and the product cost from end-to-end. I believe controlling the entire logistics network allows JD to do a lot of things that Tmall and Taobao can't do—like providing more consistency across everything they do, better customer service, guaranteeing authentic products, and delivery speed and efficiency. And as the Chinese population gets wealthier, I predict they will care more about convenience, delivery speed, quality, and authenticity as opposed to just price (even though I think JD's logistics scale will allow them to win on price as well).

JD has excelled most in the largest and wealthiest Chinese cities. JD has its largest market share in Tier 1 cities, less so in Tier 2 and Tier 3 cities, and then it drops off quite a bit in Tier 4-6 cities. The wealthier Chinese are clearly liking JD more. In addition, surveys show the younger generation prefers JD over Tmall (while Tmall is more popular with the older generations). So, JD is currently preferred by wealthier Chinese (while the entire population is getting wealthier) and by the younger generation (which is growing up and becoming a larger chunk of the population). Those are two major trends in JD's favor.

Of the several consumer surveys and third-party reports I've read, JD consistently ranks higher in customer satisfaction than Tmall and Taobao. Tmall and Taobao are more popular right now, but as more people try JD, they start to prefer it more. And this dynamic is showing up in the overall results. JD's market share of online retail has significantly increased every year I have data on, while Taobao's market share has decreased every year and Tmall has slowly increased.

The best thing about scale as a competitive advantage is that it increases over time. JD is the only Chinese e-commerce retailer that owns a massive logistics network and that's probably not going to change. To replicate what JD has built as a direct retailer with their own logistics network would require billions of dollars and many years. Even if someone started today with the money in their pocket, it would still probably take 5-10 years to replicate the infrastructure that JD has.

As JD grows, the logistics network becomes more efficient as more revenue gets spread out across the entire network (which results in lower per-order fulfillment costs). The larger and more efficient network allows them to lower prices, which attracts more revenue. More money coming in allows them to offer broader product selection, negotiate better pricing from manufacturers, and to expand their logistics network even more. And on and on. And once that flywheel reaches critical mass (which it already has), it's almost impossible for a competitor to catch up.

Risk of government intervention and regulations

When I started researching JD, my biggest concern was the risk of government regulations or intervention. The number of unknown-unknowns go up exponentially when investing in a country that I've never been to—especially one that is so different than the US. However, I've become more comfortable with the regulatory risk than I thought I would.

Throughout my research, I noticed that the other big Chinese tech companies—Alibaba, Baidu, and Tencent—had far more run-ins with the Chinese government than JD has had, and it took me a little while to appreciate why. While Chinese President Xi Jinping has openly endorsed and encouraged more entrepreneurship, tech innovation, and e-commerce, he is extremely strict on censorship. Criticizing the government is simply not allowed. And where online are people most likely to criticize the government? Blogs, social media, and news outlets—not e-commerce sites.

Think about the US: Facebook and Google get brought up in political discussions far more often than Amazon does. This is because Amazon doesn't have as much ability to influence public opinion as Facebook and Google (Cambridge Analytica anyone?). Because of this, Amazon doesn't seem to piss off the government as much as their large tech counterparts. The same thing appears to be true in China. JD focuses almost entirely in e-commerce, which is a far more politically neutral domain. The other Chinese tech giants are in areas that are much more likely to be censored by the government. And despite Alibaba's main focus being e-commerce, they have expanded into many areas—like social media and news—that have gotten them into hot water with the Chinese government.

Another common concern with JD is the weird corporate structure that allows them (and all the Chinese tech giants) to list publicly in the US. Many investors think it's possible the Chinese government pulls the plug on this foreign ownership loophole, essentially saying "We don't want our largest companies to be owned by Americans, screw the US investors, all their shares are now worth zero."

I struggle to see that ever happening. Hundreds of billions of dollars being stolen from American investors would not be taken lightly. If China completely screwed over the millions of Americans who own shares in those companies, it would permanently harm many successful Chinese companies going forward as they would almost certainly be barred from the largest source of capital in the world.

More importantly, the Chinese government recently endorsed the corporate structures that allow foreign ownership in their companies. Chinese citizens currently aren't able to invest directly into the most successful Chinese companies listed in the US, but the government is changing that. As part of this change, the government explicitly said the current structures are being kept in place. In my opinion, that endorsement largely de-risked the "China screws all American investors" bear case.

Wiedower Capital Updates

When I started Wiedower Capital in early 2015 I had zero experience working in the investing industry—only a side passion that I wanted to turn into a lifelong career. I launched Wiedower Capital with my own money and some money from my parents and, knowing it would remain that way for a while, I didn't put as much thought into how I structured the company as I should have. Three years and many lessons later, I've come to the conclusion that a) my investment philosophy has really crystallized into a concentrated portfolio of long-term positions, b) I finally feel ready and able to manage larger amounts of outside capital, and c) Wiedower Capital was not structured in a way that would optimize my chances of succeeding at either (a) or (b). Thus, four significant changes have been made to how Wiedower Capital is structured.

First, I added a three-year lockup for new investors. The main reason I added this lockup is to self-select for partners who better fit my investing philosophy. I only want partners who are just as focused on the long-term as I am. If a potential investor doesn't like the idea of investing in Wiedower Capital for at least three years, we won't waste each other's time and that's a good thing. If I am confident that my partners only care about long-term results, I will worry less about short-term results.

Second, I have put a cap on assets. If Wiedower Capital ever gets to $100 million under management, it will permanently close to new investors. Managing a lot of money acts as an anchor on returns, which is not fair to my investors. Just as important, I have no desire to manage hundreds of millions or billions of dollars. Staying small and under the radar is much more my style. I judge my own success as an investor based on long-term investment returns, not on how much money I manage.

Third, I implemented a management fee scale that decreases as the amount of money I manage increases. Similar to my explanation for capping assets, current partners shouldn't have to pay me the same amount if I raise a bunch more money from other investors. I think it's only fair that partners pay smaller fees as my assets grow. Below is the fee scale I have implemented (the performance fee will be explained next).

AUM	Qualified Client		Non-Qualified Client
	Management Fee	Performance Fee	Management Fee
< $25M	1.00%	25% > 7% hurdle	2.00%
$25M - $50M	0.75%	25% > 7% hurdle	1.50%
$50M - $75M	0.50%	25% > 7% hurdle	1.00%
$75M - $100M	0.375%	25% > 7% hurdle	0.75%
$100M +	0.25%	25% > 7% hurdle	0.50%

Importantly, you can do the math on the above fee scale and see that I can't get rich off management fees alone. A few hundred grand per year from management fees is about the max Wiedower Capital can ever earn. That should always be enough to support Wiedower Capital's overhead and my livelihood, but nothing crazy. The only way I can make a lot of money is by generating good returns over long periods of time via my performance fee. And that's how it should be.

The final change is the new performance fee, which is 25% of investment gains in excess of a 7% annual hurdle rate. Importantly, I don't collect this entire performance fee each year. Instead, it goes into a reserve that gets carried over every year. During years when I return less than the 7% hurdle rate, that reserve is depleted by the amount of my underperformance. Basically, the reserve increases and decreases as my investment returns exceed or fall short of 7%.

How I get paid is by withdrawing 25% of the running balance of this reserve at the end of each year. This means that even if I have a really good year, I still have to perform well for the next 3-4 years to get the full benefit of that earned performance fee. If I don't, the majority of that performance fee will be given back to the client (in other words, performance fees can be clawed back). When I earn less than 7%, the reserve is depleted. And if the reserve goes negative, I have to make that amount up (and exceed the annual 7% hurdle) before earning a performance fee again. This new fee structure should assure that my investment strategy is aligned with a long-term performance incentive.

All of the above was done with one goal in mind: to align my long-term investment strategy with my partners and my own incentives. If all three of those are aligned and pointing in the same direction, our chances of success are greatly increased.

(Thank you to Nick Sleep for pioneering the above type of fee structure. Imitation is the best form of flattery!)

A Note About Appendix 1

You will notice an appendix to this letter titled Wiedower Capital's Investment Philosophy. While I've written many letters discussing my investment philosophy over the years, each individual letter may only include a snippet of that philosophy. If someone is reading this letter and hasn't read my previous letters, they may not fully understand where I'm coming from. Even if someone has read my past letters, they still may appreciate a reminder of my core principles that are driving the things I'm writing about in that letter. Going forward, I will include this appendix in every letter.

The goal for this investment philosophy appendix is that it's timeless. All investors evolve their strategies over time, but my hope is that I very rarely need to edit Appendix 1. Even if my strategy does evolve, these ideas should remain at the core of how I look at the investing world. They are purposely broad, but they encompass the most important aspects of my philosophy.

Travis Wiedower
Managing Director

Appendix 1: Wiedower Capital's Investment Philosophy

1. Long-term focus: I look at companies through a long-term lens. When I invest in a new company, I go in with the mindset that I will own it forever (while recognizing that won't come to fruition very often).

   A company is worth its future free cash flow discounted back to today. A discounted cash flow analysis shows that the majority of a company's intrinsic value comes from the distant future, not near-term results. If how a company will perform over many years is the majority of its worth today, then the durability of their competitive advantage is of paramount importance.

   Because of this, my research is focused on how an industry may evolve over the next 5-10+ years and if a company's competitive advantage can expand within that evolution. This is only possible if the CEO is focused on, and incentivized by, the long-term success of the company. Often, the CEO traits I look for are found in passionate founders who are internally driven to see their own business succeed.

2. I'm very picky: The vast majority of companies are un-investable for me at any price. I have a small circle of competence (that is slowly expanding) and I have zero tolerance for management that isn't aligned with me.

3. Learning mindset: Even more than investing, I love learning. Investing just happens to be a perfect outlet for that—there will always be more companies, industries, and countries to learn about. Beyond that, a lot of outside disciplines indirectly help my investing. Much of what I consume on a weekly basis may not directly benefit my investment results, but I believe there is a lot of value to learning broadly and trying to understand the world better.

4. Alignment of interests: As much emphasis as I put on finding CEOs who are aligned with outside investors, I also want the same alignment between myself and my partners.

   Wiedower Capital is structured to align my own incentives and my partners around a long-term investment strategy. My performance fee is earned over multi-year periods and new partners are subject to a three-year lockup. In addition, performance fees can be clawed back, management fees scale down as assets under management increase, and assets are capped at $100 million.

Appendix 2: Historical Results*

Period	Wiedower Capital	S&P 500
2015	-11.91%	-1.37%
2016	19.19%	11.95%
2017	22.28%	21.82%
2018 1st Half	2.72%	2.52%

Cumulative	31.88%	37.90%
Annualized	8.62%	10.07%

* Started February 24, 2015. Wiedower Capital results are net of fees and are based on a model account that has been active since inception. The model account pays fees as a non-qualified client, which is currently 2% per year. All accounts are managed the same, but individual account results may vary from the above results based on different fee structures and minor position size differences. S&P 500 results include dividends.