



Linden Rose Investment

Fourth Quarter 2018
Letter to LRI Clients

Annual Return

Year	Linden Rose Investment	S&P 500 Index
2018	-14.22%	-4.39%
2017	55.51%	21.82%
2016 2nd Half	18.41%	7.82%
Since Inception	57.92%	25.57%

Dear Partners:

For the full-year of 2018, the consolidated return of Linden Rose Investment (“LRI”) was -14.22% and the return of the S&P 500 index was -4.39%. The annual return of LRI was about 10% behind the S&P index in 2018. Since its inception, the total consolidated return of LRI has been 57.92%, versus the S&P return rate of 25.57% over that period. The performance of LRI in 2018 was not satisfactory, but the overall performance since inception is strong. So the total consolidated return of the early LRI investors was strong, but the return of the newly joined partners/investors in 2018 was a little disappointing.

As we have repeated in the previous quarterly letter, when we perform well, we always remind ourselves that the stock market has its own way. There will be highs and lows and one day there will be temporary poor performance. Just like after the autumn, the winter will one day come. 2018 was such a year. If we look at each quarter in 2018

separately, the returns of first three quarters were basically flat, and the return of the fourth quarter declined with the overall market.

All of this is simply an off year.

Looking back on 2018, if we want to sum up the lessons learned, we think we did not do well with our equity trading. We sold some stocks at the so so prices (we did not sell many), while we bought some at prices not low enough. This may be a common problem for value investors who tend to be reluctant to sell stocks in a portfolio (it is not easy to find a good company) and rush to buy stocks if the prices have dropped a bit when cash is available. We will constantly remind ourselves to keep patient. We will try to do better in trading, but we can't predict the short-term market, so our near-term return may be lackluster.

When our portfolio fluctuate up and down with the market, we made some position adjustments. We sold Amazon in the first quarter of 2018, because it is hard to convince ourselves that it is not speculative at the price of \$1500-\$1600 per share. We sold Netease and JD.com in the second half of the year (luckily before the incident related to JD.com's CEO). Most of the cash was put in Pinduoduo and the rest was used to buy more other positions. When the prices of NetEase and Tencent both fell sharply, we did not hesitate to buy Tencent which has more diversified business and revenues. It doesn't rely on online games only, it also monopolizes China's social network. The self-evolution of the business model and the improvement of gross margin of JD.com that we have been expecting for several years did not realize. On the contrary, JD.com continues to build large-scale logistics warehouses, even some are not being utilized. We feel that JD.com's business model has reached its ceiling. The timing of selling Netease and JD.com stocks was not optimal.

On the surface, we have a relatively big decline in 2018, but in the long run, 2018 gave us a good opportunity to initial new positions and adjust existing positions (I hope this will still be correct if we look back three years later). Of course, if we could have been more patient, it would be even better. If we carefully review the companies we have, the current portfolio is in the best shape since LRI was founded. Only Pinduoduo is at the stage of tremendous growth and not yet profitable, while other companies in our portfolio are basically cash cows and their moats are expanding rapidly.

In the days of high volatilities in the stock market, we also want to remind everyone: our goal is long-term results, short-term fluctuations in a year are just noises. As long as the stock market exists, it will move up and down. It is unrealistic to expect that the stock market only goes upwards and does not decline occasionally. Or it is irrational to be afraid and fleeing the stock market because of the fear of the bear market. No one has proved that Timing Market can succeed. By escaping from the bear market's plunge, it is also very likely to miss the bull market's run. In 2009, the "stock masters" who made a fortune in the financial crisis basically disappeared in the next 10 years of bull market. And the investors who were able to withstand the financial crisis and hold the great companies in the wind and waves made a fortune in the later bull market although they suffered a large drop in the short term. As the lyrics of a song say: "Without going through the wind and rain, how can you see the rainbow? No one can succeed easily!"

The famous Chinese entrepreneur and investor Duan Yongping once said: "Shouldn't the investment strategy in the bull market and the bear market be the same?" Yes, the difference between the bear market and the bull market can only be seen clearly when you look back. How do you distinguish between a bull market and a bear market? By the time you see that the past few years are a bull market, a bear market may have begun. "If you wait for the robins, spring will be over." When you see a bear market, a bull market may have started for a long time. Besides, why should we distinguish between a bear market and a bull market? Since we are making long-term investments, the simplest and most feasible way is to actually invest money in great companies and ride the waves of the stock market up in the long run. As Warren Buffett said: "We want to choose players who can swim in the big waves, instead of predicting the storm." As long as the companies in our portfolio are indeed great companies with long-term profit growth, we are not afraid of shorter term stock price fluctuations. Our goal of return is to double or grow multiple times in five, ten or twenty years. Doesn't it sound silly if we miss the opportunity to have multibaggers only because we are afraid of the stock market may fall 20%?

Let's talk about the new position in our portfolio: Pinduoduo (PDD).

Pinduoduo is not a conventional company. Pinduoduo was founded when the China market accepted the status quo of the existing e-commerce landscape and thought its formative phase had come to an end. Within three years, Pinduoduo has attracted over 400 million active buyers and over 2 million merchants through a new shopping format and experience. In the 12 months ended September 30, 2018, Pinduoduo generated 344.8 billion RMB in GMV on its platform. It is expected that the GMV for the whole year of 2018 may exceed RMB 400 billion.

Business Model

"Pin" means the aggregation of consumer demand, which enables factories to get many dynamic sales leads and establish a direct link with consumers. Through this link, Pinduoduo "customizes mass production + compresses supply chain" and "saves more for consumers".

Pinduoduo has a set of systematic operation logic and many ways to promote sales for merchants. There are many resource channels and registration entrances for the accumulated sales data. Through these registration entrances, the merchants may gather a lot of data after hundreds of orders, such as price, quality of service and goods, logistics, click rate conversion rate, refund rate, and dispute rate. With these data points, Pinduoduo scores the products. Then, based on this information, the higher the scores, the more traffic the merchant can get from the Pinduoduo platform. With this mechanism, the merchant can sell more orders and create the mass-selling product. This mechanism is similar to Google's search ranking. The more likely it is a mass-selling product, the more likely it is placed in the most traffic-efficient slot, so that the efficiency of the entire platform is optimized.

Second, for products, the logic is different than other e-commerce companies as well. Many e-commerce companies focus on the "search" function, which provides the width of the products rather than the depth. Pinduoduo focuses on the mass-selling products or the depth of the SKUs. Therefore, the cost of the goods and the gross profit can be significantly reduced, and the profit can be made by the large sales volume. There are several advantages of this: the cost of the product is very low, and the inventory is much less compared to the other e-commerce models. From this point of view, it is a bit like Costco. The number of SKUs is small, but the volume is large with small unit profit but quick turnover.

Pinduoduo learns to understand people through the aggregation of orders and people's recommendations. In the future it will transition to AI recommendations. There is almost no search in the Pinduoduo APP and there is no shopping cart. You can imagine that it is like the flow of information in the Toutiao APP. At the same time, compared with other e-commerce companies, Pinduoduo doesn't have shopping cart in its APP which simplifies the online shopping process, and reduces the bottleneck that restricts the development of e-commerce in suburban and rural areas in China, making online shopping for elderly population in these areas possible.

The reason why the price can be cheaper than supermarkets is that it cuts off all the intermediaries. Due to this reason, although merchants need to pay the shipping fee and the selling price is cheaper than the supermarket, merchants still make more than before.

A summary of the business model:

On the one hand, Pinduoduo has been deeply involved in and reorganized the supply chain through the market, creating many new brands that can grow up from the bottom up. Taobao and JD.com rely on millions of merchants and brand owners to play their part in their respective fields of expertise, focusing on the operation and supervision of the platform, and not going deep into the back-end supply chain. Pinduoduo is much different and has improved the supply chain, which has led to many mass-selling products with huge volumes.

On the other hand, Pinduoduo positions its platform “more affordable and more fun”, and it does not follow the steps of the increasingly rich SKUs and the higher price of the traditional e-commerce platform. It is a “less SKU, great inventory

depth”, more affordable, and completely different model. To put it simply, the “more affordable” is a more comprehensive and overall beneficial, and the price is much lower. The traditional e-commerce platform is often dominated by online stores, whose rankings can be created by a single low-priced product.

Therefore, it is difficult for traditional e-commerce companies to control all the individual products, and it is impossible to control the tone of the entire platform. Finally, under the choice of consumers and other markets, it has embarked on the road of consumption upgrading. Pinduoduo controls the distribution of single items, thus fulfilling its vision of "more affordable and more fun".

In general, Pinduoduo is becoming the most efficient e-commerce platform providing the lowest cost and highest efficiency to customers.

Values

Pinduoduo's core value is "本分" (Ben Fen). It is difficult to express it perfectly in English, but it essentially means to adhere firmly to one's own duties and principles.

There are several layers of meaning here:

- Be honest and trustworthy;
- Discharge our own duties and responsibilities regardless of others' conduct;
- Insulate our minds from outside pressures so that we can focus on the very simple basics of what we should be doing;
- Never take advantage of others even when we are in a position to do so;
- Self-reflect and take responsibilities when problems arise instead of blaming others.

Future of Pinduoduo

Supply chain upgrades will be a strategic focus of Pinduoduo for a long time. The future model of Pinduoduo is to make the upstream manufacturers customize for mass production. At present, the company has been working hard to open up the supply and demand information link, so that the information between original productions and the consumers is as symmetrical as possible. By utilizing huge amounts of consumer data and feeding back to the supply and trading chain, Pinduoduo can achieve the supply-side convergence growth.

Valuation

It's still very difficult to value Pinduoduo due to its rapid growth rate, and I can only give a rough estimate here.

Pinduoduo is an e-commerce platform. Similar to Taobao, it generates revenue from certain advertising slots on the platform. The monetization rate of Pinduoduo has been rising rapidly, which in Q3 2018 reached 2.5%. Assuming the GMV reaches RMB 1 trillion in 2020, and the monetization rate is 4% in 2020 (this rate is still below Taobao. Considering the efficiency of Pinduoduo is higher than Taobao, its future monetization rate may be higher than Taobao), the gross revenue will be RMB 1 trillion * 4% = RMB 40 billion. And assuming half of the gross income is net profit (50% net profit margin), which is RMB 20 billion or about 3 billion US dollars, if we give a conservative 20 times P/E valuation, it is 60 billion US dollars, which is equivalent to twice the current market cap. Of course, we are optimistic about the long-term future of the company, and the \$60 billion valuation is only a rough estimate.

Additional Thoughts:

It took Pinduoduo only three years from inception to a Nasdaq listing, which was viewed as a business miracle. But in fact, improving the efficiency of the supply chain is tedious work. More than 90% of the Pinduoduo employees graduated from prestigious universities in China or overseas, and a large part of them came from big domestic or foreign Internet companies. Smart people use the most “basic” method to do the “hardest” work, use the lightest Internet model to do the heaviest work, and there is no miracle in the rise of Pinduoduo. All the miracles are based on hard work. At the user end, Pinduoduo constantly optimizes the efficiency of the platform through artificial intelligence, and continuously transforms the supply chain to reduce costs. The lower the cost, the lower the price, which will attract more new customers. The more customers, the lower the cost of traffic and the higher the likelihood of promoting a mass-selling product. The more mass-selling products, the more merchants will be attracted, thus forming a benign cycle of the flywheel.

Alibaba has the genes of e-commerce. Tencent has the genes of games and social genes. It is very difficult for them to enter each other's fields. Pinduoduo's team has past experience of both e-commerce and games. In the three years since the establishment of Pinduoduo, from Pinhaohuo to Pinduoduo platform, and now to the “new brand plan” to support a thousand brands, the evolutionary ability of Pinduoduo's team is amazing.

Pinduoduo voluntarily gave up 20% of the IPO price increase and all employees' options are locked-up for three years. At the time of counterfeiting, Huang Zhen asked employees to “use the nailing spirit to solve the fake problem one by one”. Pinduoduo launched production visualization platform recently (that is, through the live broadcast technology to open the flow of information between the production end and the demand side, so that the whole process of product design, production, and manufacturing is visualized). We have seen a lot of “benfen” and insists on doing the right thing in the corporate culture. We have seen the spirit of the company's courage to forge ahead. At

the same time, what Pinduoduo has done so far is also helping China's manufacturing industry to transform into branding, in line with China's development strategy, and also bring certain positive social effects. Only by helping society solve problems can enterprises have more value. Enterprises that pursue goals above profits can go further. With a such CEO, such a team, such a corporate culture, such a business model, it is very possible for Pinduoduo to become the second Taobao one day if they are given enough time. Perhaps the days of "the opponents can't be found with a telescope" for Alibaba are gone forever.

Pinduoduo CEO Huang Zheng

Huang Zheng graduated from Hangzhou Foreign Languages School in 1998. In 2001, he occasionally got to know Ding Lei, the founder of NetEase, and was recommended to Duan Yongping by Ding Lei. He graduated from Zhejiang University in 2002 with a major in computer science. In 2004, he graduated from the University of Wisconsin-Madison with a master's degree in computer science. Then he joined Google. In 2006, Duan Yongping won the bid for Buffett's lunch for \$620,000. Huang Zheng was involved as an escort. In 2007, he left Google for purpose of starting up his own business. In April 2015, he founded Pinhaohuo. In September 2016, he merged Pinhaohuo and Pinduoduo and served as the chairman and CEO of the new company. He has experienced entrepreneurship in the retail, e-commerce services and games, and Pinduoduo is his fourth venture.

(1) Huang Zheng met Ding Lei when he was a undergraduate student and met Duan Yongping when he was a graduate student. When he founded his first start-up, Ding Lei, Duan Yongping, the founder of Taobao and the founder of SF Express all invested in the business. However, Huang Zheng still said that he was not involved in any social circle. In addition to his talent and technical background, he is very capable and

hard-working. Bezos, Buffett, etc. are all such people.

(2) The first principle of "Benfen" is not to lie to yourself and do the right thing. The biggest disadvantage of cheating others is that people finally cheat themselves. This is the most important thing that Huang Zheng learned from Duan Yongping. There is no relationship between "Benfen" and the character. It is actually "rationality", which is the first factor in all thinking, calculation and decision-making.

(3) Huang Zheng understands technology, but does not use an "algorithm" and "AI" to fool people. The distributed intelligent system described in Pinduoduo's IPO prospectus is integrated with human algorithms. Algorithm-driven companies, scarce in China, have huge opportunities.

(4) Very few CEOs are masters of system engineering, who can put different variables in technology, business, society, humanity, and market into a simple and complete equation for quick and sharp decision-making. There are very few CEOs with such abilities and talents, and Huang Zheng may be one of them.

Summary

Pinduoduo used the WeChat platform to obtain a large number of users at a low cost. On the user end, it improved the platform's efficiency to the extreme through artificial intelligence and big data; it reduced intermediate links in the supply chain, constantly transformed the supply chain to reduce costs, and enhance the brand; extremely high cost effectiveness has further attracted more users, thus forming a closed loop. The team with experience in the gaming industry has a lot of understanding of human nature that other e-commerce companies do not have. By embedding more game genes in the Pinduoduo platform, it creates great stickiness after customers enters the platform and makes them feel "buy more save more".

We have a huge advantage when doing research on PDD: we have always admired Huang Zheng's mentor, Duan Yongping. From Bubugao to OPPO and vivo, we are deeply aware of how strong the corporate culture of "benfen" and "rational" values. In this world, only few people can do well in both business and investment. Duan Yongping is one of them, and Huang Zheng is also. The more we understand Pinduoduo, the more we like the company and its team. From Huang Zheng, we can see the shadow of the younger Duan Yongping. If we dig deep inside the company's financials, we find that there is actually no need for it to go public at this time. The fund from C-round financing before the listing was still lying in PPD's bank account, and the company's cash flow has been positive. At this time, Pinduoduo's IPO gave us a chance to grow together with it. In the "selling fakes" buzz after the listing, we started a position near \$19. I hope when we look back after 10 years, we will think that this price is really cheap today.

Conclusion

Time flies, it has been three years since Linden Rose Investment was founded. We are not as strong as the return in 2017 shows, nor as weak as the 2018 return shows. We are doing the same thing as always: trying to find and track great companies and grow with them. We insist on doing the right thing. We constantly strive to improve our cognitive ability. Although the road ahead may be bumpy, the future is bright. Thank you to all the partners who have accompanied us on this journey, as well as those who care about our growth. We look forward to continuing to grow the investments for our partners.

As always, we'd like to thank our investors for their continued support and trust. While in the short-term our results may occasionally be volatile, we know that overtime, our profits will be worth it. If you have any questions, please feel free to contact us. You can

either call us at (973) 841-7158 or email us at bing@lindenroseinvestment.com. We are always happy to meet new investors who you think may benefit from our services, or who would like to learn more about our investment philosophy. If you know anyone who may be a good fit, please have them reach out.

Stay hungry, stay foolish!

Thank you very much!

Yours truly,

Binglin Li
Managing Partner

Feng Peng
Managing Partner

January 20th, 2019

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