January 28th, 2023

Dear Partners,

We started the fund to invest in companies with amazing products, products that create enormous value for customers and that customers love. We felt there was an insufficient focus on product by public market investors, whereas our experience and study of business history seemed to clearly indicate that amazing products tended to create outstanding business outcomes.

There's direct causation, as in a great product itself drives growth; but perhaps even more importantly, a great product provides us an extremely valuable signal into a company's management and business culture. Great products never happen by accident but instead are the result of extreme focus and entire-of-organization alignment around product. That's a great signal for a company's future and very difficult for competitors to copy.

Quality in product is hard to quantify, which is why fewer people focus on it when there are plenty of other metrics to analyze. But quality is real. We've found that across very different categories, customers tend to describe their experiences with quality products in similar terms, and companies with quality products tend to describe what they focus on in similar terms (one example: truly embodying "customer obsession, not competitor focus"). We use these patterns to find other companies with quality products.

By concentrating our attention on product quality, we have a different lens to view the world than do most other investors. To find ideas, we use amazing product as a screener, rather than as just one element of the investing mosaic. This leads to a different set of ideas that we hold in our portfolio. Some of our companies are heavily lossmaking; some operate in very competitive markets; some are subscale vs. much bigger incumbents. Others are dominant and highly profitable, yet nonetheless for various reasons have their product quality underappreciated and their equities significantly underpriced.

Of course, not all great products end up being great investments. It is our job as investors to pick the ones that will be. In this regard, our extensive past experience as short sellers is helpful. We have experience seeing through and betting against charismatic management teams and attractive narratives not backed by substance. We do deep research to make sure we understand the reality of things on the ground. We tend to be skeptics and are wary of companies that achieve success too fast or stories that sound too good to be true.

Given this philosophy around amazing product as an investor, naturally, my goal as a businessman is to deliver an amazing product to our partners. The main driver of this will of course be returns, but other elements matter as well. We are in the business of trust; and I aim to be unfailingly trustworthy, transparent, and reliable. I view the fund as not just an institutional product to deliver a factor for a diversified strategy, but as a "all-in" portfolio in which I place most of my net worth and intend to pour all of my energy over the long term to come. Our goal in terms of returns and risk is clear; and over time, if we achieve our goal, then my hope is that we will have delivered to you an amazing product.

Idea selection

After a company clears the necessary condition of having a great product, what we focus on is growth relative to valuation. Ultimately, future growth not already paid for in the current price is what creates real business value and generates gains for our portfolio.

This may seem obvious, but for us the "not already paid for in the current price" condition is key and is the reason we adjust our portfolio regularly to move into areas with better opportunities and less-priced future growth. We are less willing to sit completely still in the same company as price rises rapidly, unless there is a corresponding increase in future expectations of growth (which sometimes happens). We are keen not to repeat mistakes made by other investors over the past few years on that front. We love growth, which is *the* main creator of long-term value; but we look at high-growth companies with a value investor's mindset and worry constantly about the asymmetry and downside risk involved in paying high valuations.

In terms of growth, the best way to find growth is to of course find sectors or themes that are growing and look for investable targets within those sectors. What makes investing interesting and keeps us on our toes is that many fast-growing sectors have no investable targets. This may be because the sector will likely commoditize with limited value created for investors, because the products in the market are not great (a no-go for us), because we don't and can't understand the technology involved, because the fast-growing businesses are contained within larger conglomerates and not stand-alone, because the best companies are private, or, most often, because the growth is already recognized by others and valuations are too high. So when we find the rare combination of high-growth sector with well-matched investment target, we jump on it.

Currently, what excites us most is *monetizing the growth of data*. At first glance, this may sound far too generic and obvious of a theme. Doesn't everyone know data is growing? Haven't we heard "data is the new oil" (and arguments for why, in fact, it isn't) ad nauseum for well over a decade now? But actually, we'd flip this thinking – the more obvious a theme, the better, because there are stronger tailwinds behind it and it is more likely to be true. "Consumer internet" or more broadly just "digital penetration of X" generated extremely strong returns long after everyone knew about it. What matters more is if 1) the growth is real and durable, 2) the business models available are such that return-protecting moats can be created, 3) one can benefit directly from the main stream of growth and not a second derivative, and 4) substantial future growth is not paid for in the current price. (Consumer internet fit these characteristics and paid handsome dividends for us and many others for a long time, but that tailwind appears to be diminishing and hitting the flatter part of the S-curve. Hence, our need to find new themes earlier in their stages of growth.) For the companies we have in mind for this data growth theme, #1-3 were long true but #4 was not; the valuation piece falling into place has enabled us to make large investments here.

Confluent

Our largest "monetizing data growth" investment is Confluent. The founders of Confluent were the creators of Kafka, an open-source technology that revolutionizes the movement of data (or "data streaming") within companies. Confluent in turn created a series of products that commercialized Kafka, culminating in Confluent Cloud, which offers to customers fully managed Kafka as a cloud service. Kafka and Confluent Cloud are both amazing products.

Within companies, data constantly needs to be moved around as customer actions are recorded (e.g. clicks on a website), data moves from operational systems to analytical ones and back, services performing different functions talk with each other, front-end systems talk to back-end systems, etc. Legacy solutions for moving this data suffered from two main drawbacks: 1) they weren't real time, and often ran in "batches" (think about a retail store that uploads data to a central system once per day at closing, or why Instacart sometimes mistakenly says a grocery store has a certain item in stock when it doesn't); 2) they transferred data point-to-point rather than one-to-many, meaning data produced by one service wasn't readily available for other services to use without explicitly building new connections. As data volumes continue to compound at 20-30% annually (estimates vary) and using data becomes more important, these problems become more acute, and companies not fully leveraging their data fall further behind.

Kafka (the open-source technology developed by the Confluent founders) solved both of these drawbacks, making it far better than the previous data streaming technologies. Kafka transfers data in real-time and in a one-to-many format. In the Kafka "publisher-subscriber" model, the data produced by any "publisher" service can be consumed by any "subscriber" service in an organization, which leads to network effects within organizations as increased data streams available lead to engineers steadily finding new uses for that data. These improvements catalyzed huge adoption of Kafka. After just 12 years post-launch, Kafka is now used by >100,000 organizations and >75% of the Fortune 500. Kafka adoption is real and growing at a rapid pace, driven by urgent demand for what it offers. This goes beyond the need for "real-time" use cases vs. non-real time ones, a distinction which investors sometimes get hung up on; the architecture for Kafka vs. legacy solutions is superior for all use cases regardless of timeliness, and there are meaningful benefits to moving the entire organization to Kafka rather than just a subset of use cases and data streams.

The investment question then becomes: can Confluent sufficiently monetize Kafka to become a very large business relative to what the stock is pricing today? We think the answer is a clear yes.

To start, Kafka is a complex technology and difficult to manage, even for the largest, most sophisticated companies. Confluent's first paid product, Confluent Platform, was a bundle of support from Confluent as well as a host of additional features that make Kafka easier to manage and cheaper to operate (e.g., a control center for Kafka, pre-built connectors to integrate any source of data, tiered storage, etc.). This product received strong adoption, reaching $323 million in revenue in 2022 vs. $54 million in 2018, but suffered from the drawback that companies still had to manage their own Kafka, which was still difficult and required teams of expensive engineers.

Confluent's next paid product, Confluent Cloud, fully addressed these issues. Confluent Cloud is fully managed Kafka as a service, delivered over public cloud. Confluent takes over the running of Kafka, greatly smoothing its operation for customers and eliminating the need to have a large engineering team managing it. Confluent charges a premium on the infrastructure costs, but conversations with customers indicate that the total cost of ownership element is compelling due to the savings on engineers. Furthermore – and this is true as a driver for all managed services – companies are increasingly realizing that their scarce engineering talent should be focused on building elements core to their business and which generate competitive advantage, rather than on reinventing the wheel and recreating subpar versions of services that have already been developed by specialist vendors like Confluent.

Versus Confluent Platform, Confluent Cloud has greater product-market fit and is poised to power the next wave of Confluent's growth long into the future. As a consumption-based model, Confluent Cloud captures the growth of its customers' use of data, including new use cases being placed on Kafka, which gives it a natural per-customer tailwind as data volumes grow; Confluent Cloud's net revenue retention rate is currently greater than 150%. Confluent Cloud revenue grew 124% in 2022, reaching 36% of Confluent's total revenue, and we think it will grow close to 80% in 2023. Because Confluent Platform is growing much slower, benchmarking Confluent just from a current total revenue growth basis (our estimate of ~36% in 2023) understates the long-term growth profile of the company when considering the growth from Confluent's key product.

Our calls with customers were universally positive on the utility and adoption of Kafka and near-universally positive on the value of Confluent Cloud. This was unusual, especially in the current economic environment, and was key to getting us interested and digging deeper. Our initial bias as somewhat-familiar observers of the company, probably shared by other investors, had been concern over 1) what percent of use cases need real time data streaming, which seemed niche as a use case; 2) concern that managed Kafka would commoditize and that Amazon's competing MSK product was in a strong position due to a lower price than Confluent Cloud; and 3) concern over Confluent's heavily lossmaking profile (-41% non-GAAP operating margin in 1Q22 and the whole of 2021) in an environment that increasingly valued profitability. Deeper research conclusively disproved concerns #1 and 2, and recent actions by Confluent management have completely changed the trajectory of concern #3. Confluent margins are rapidly improving (-22% non-GAAP operating margin in 4Q22) and the company has recently guided to non-GAAP operating margin breakeven in 4Q23, which would represent a 41-point margin swing in 7 quarters and of course completely change the margin profile of the company and its previous categorization in the "heavily lossmaking" software category. (However, stock-based compensation for Confluent is still very high, so there is much further work remaining for the company to get to true GAAP breakeven.)

In terms of competition, our research indicates Confluent Cloud is in a league of its own, with Amazon MSK a distant second in terms of product quality (though not revenue, as many customers use it as a first step into managed Kafka before later moving on to Confluent Cloud). Competing managed Kafka products from Azure (Event Hub) and independent players like Aiven then further lag Amazon MSK. There are structural reasons for this, which MongoDB's example in holding off cloud copycats demonstrates (MongoDB is another one of our "monetizing data growth" investments) – like MongoDB, though with some differences, Confluent effectively controls open-source Kafka, which allows it to reserve its best new innovations for its paid product rather than releasing them to open source, which other players spin up into a managed service. Over time, the gap with open source and by extension Amazon MSK and others widens, and in recent years that gap has widened significantly as Confluent has released a slew of paid features that are considered must-haves by customers who are serious about Kafka. Rather than commoditizing, calls with Amazon MSK former employees and MSK/Confluent customers indicate the gap is growing over time, as only Confluent is focused all-in on innovating in data streaming.

Confluent currently trades for 6x 2024 revenue, a seemingly low multiple when considering its growth, margin potential at maturity, and its position as a dominant infrastructure asset crucial to how data flows through organizations. We estimate revenues will grow at close to a 30% CAGR from 2023 to 2027, and we should reap the benefit of that growth, net of dilution from stock-based compensation issuance.

Conclusion

2023 looks likely to be another highly volatile year. Green markets are OK, but deep red markets are what get us really excited. Our eyes light up and our idea generation work spins up into overdrive, as declining prices open up entirely new opportunity sets previously closed to us due to valuation. We buy as stocks reach our hurdle rate, our exposure increases, and our portfolio becomes primed for higher future returns.

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