

# FCL*Capital*

August 2018

YY

## 1 – Introduction

Investing is definitely one of the ultimate puzzles of mankind. The most successful strategy so far invented to consistently beat the market in long periods of time is investing in relatively small companies that will outperform their peers and grow their revenues and earnings in the future at a rapid clip while at the same time being able to not overpay for those companies.

In other words, a mix of value and quality investing, or, to use the market parlance, GARP-growth at a reasonable price.

Note that there are at least two different challenges embedded in that:

a. To be able to invest in companies that will thrive. In other words, to be able to be a good business forecaster. Note that it does not suffice to pick promising industries, we need to pick companies that will conquer their competitors. Evidence shows that it is better to pick a good company in a bad industry than the opposite.

b) To be able to not overpay for good companies. In other words, and implicit in that: to be able to realize who will be tomorrow's winners BEFORE most people or at least in disagreement with consensus opinion.

This letter is about one that this house thinks will be of those companies.

The good news is that the four BRIC countries this house specializes in – Brazil, Russia, India and China- are the places we think most of those companies will come from during the next few decades. Almost on a daily basis we are introduced to new companies that we think will be among the huge winners of the new world order of tomorrow.

One interesting caveat: in investing what has worked in the past probably won't work in the future – if anything there is a negative correlation – the sectors, companies and business models that thrived in 20th century USA and Europe are unlikely to be the winners of the 21st century in Asia. New models and new ways of doing business shall emerge.

This letter will be about one of the major investments of this house -In fact one of the largest positions of our Opportunities fund – and one we think is fascinating because of its confluence of factors – a Chinese company, with a completely new business model with no obvious peers in western markets that due to the Chinese bear market and a momentum driven approach most investors including western ones have about China is being sold at what we think are insanely cheap prices.

YY is a streaming company founded by a man called David Lee in the city of Guangzhou, in the Guangdong province (the same province of many famous Chinese companies like Tencent, DJI and another of this house's investments, Vipshop.)

So, let the streaming begin.

## **2 - Background**

YY was founded in 2005 at the heart of what is probably the most promising region for the global economy at the 21st century: southern

China, most specifically the Guandong province that also hosts names like Tencent, Huawei and DJI.

The company is the largest live streaming social media provider in China. It operates two main media platforms, YY live, which consists of thousands of performers hosting curated shows for target audiences, including music, singing, chatting, cooking lessons, variety shows, magic performances and a lot more, and Huya, an integral listed subsidiary that is also listed in the US markets and consists mainly of video games streaming in a model that is similar to a US based Amazon subsidiary called Twitch.

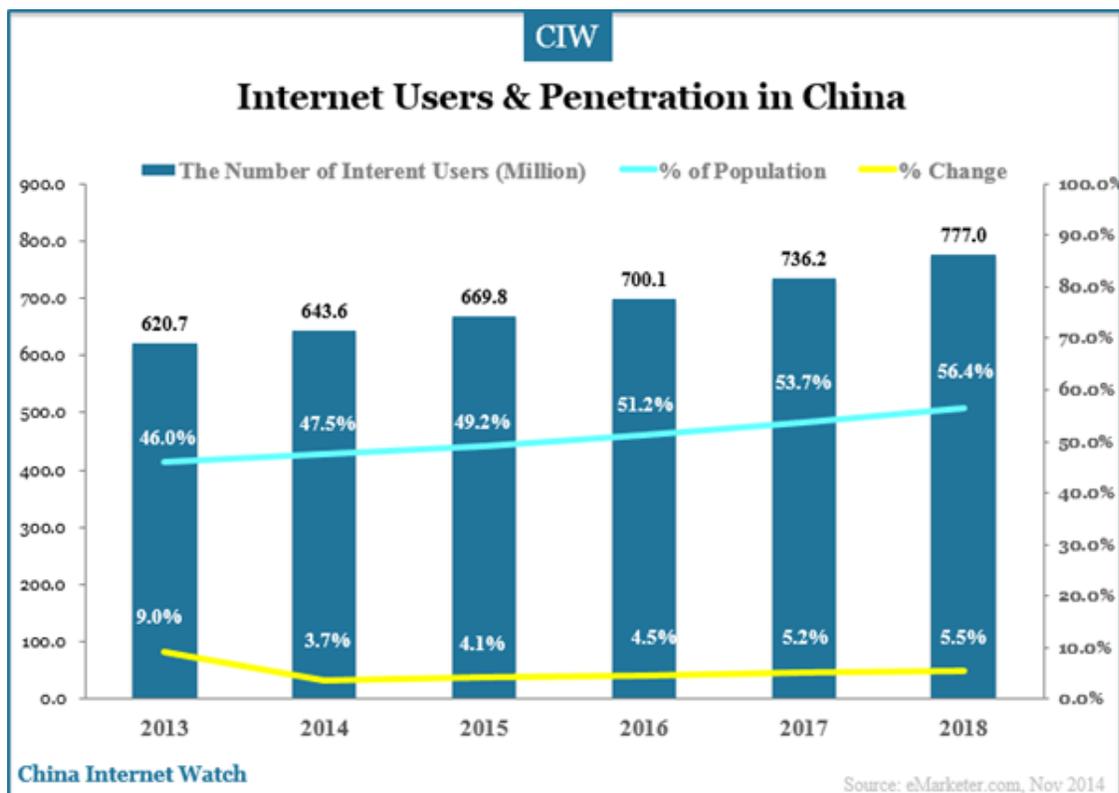
Finally, the company is also on the process to becoming the majority owner of Bigo, a leading live streaming service focused in India and southeast Asia.

Overall the company boasts 80.2 million unique monthly users ( MAUs) as of June 2018. <sup>1</sup>

Of course, the explosive growth was helped by the fact that China, over the past 10 years became the world's largest internet market

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<sup>1</sup> <http://ir.yy.com/static-files/88a221d9-ac18-4216-996b-6107ded223c9>



The company’s main competitor is Momo, although there are differences in their business models: YY is more focused on building its “moat” through an unmatched ecosystem of how performers, views and engagement and this way becoming a “Netflix of tomorrow” of sorts. <sup>2</sup>

Momo meanwhile recently acquired what is sometimes known as “China’s Tinder”, a company called Tantan, and hopes the relationship app fuels traffic to Momo’s main website and vice versa in a synergistic way.

<sup>2</sup> <https://www.scmp.com/lifestyle/arts-entertainment/article/1923048/five-most-popular-hosts-chinese-live-streaming-site>



**The comedian Li Ge, one of the top hosts of YY live**



Xia Keke, whose show averages 185 thousand viewers per night.

One of the open questions in the sector is that if this will be a “winner takes most” market like internet search and ride hailing or a more fragmented sector. While it is still too early to say for sure and China’s giant companies are definitely looking at the sector, so far, we feel pretty confident about YY’s unrivalled ecosystem of performers <sup>3</sup>, viewers, government approvals and recognition, strong engagement among its viewership and ability to monetize its content.

3 <https://technode.com/2016/06/20/chinas-livestreaming-hosts-motivated-money-not-fame/>

## Leadership in key SEA & Middle Eastern Markets

- US\$272m further invested from YY in June 2018
- YY also holds an option to purchase additional Bigo shares to exceed 50.1% of the voting power in Bigo after May 2019



 Geographies where Bigo Live is among the top 10 grossing iOS apps locally<sup>1</sup>

 Bigo Live's geographic presence



BIGO LIVE

Live streaming platform



LIKE

LIKE

Short form video editing and sharing platform

That's where the difficulties start: we are facing a new business model and most importantly, one where the most important players are far from western markets. Meanwhile, both YY and Momo decided to list their shares in western markets since that's where most sophisticated investors still are.

The result is a sector poorly understood, poorly priced where momentum and rumors dictate prices. The result, as we will see, is an irrational valuation.

### 3 -The Chinese crash - a momentum driven market. Numbers

If there is one major difference to be understood between Chinese and the west, especially American markets is that in the former ones (comprised by Shanghai, Shenzhen and Hong Kong stock exchanges) retail investors are in the driver's seat.<sup>4</sup>

Unlike the US, those markets haven't yet developed the large-scale institutionalization (except for a few outliers) and sophistication western investors are used to.

As a result:

- The market is momentum driven, since there are less stabilizers, like institutional investors rushing in when prices fall too far.
- There are more price inefficiencies.
- Boom and burst cycles are stronger and faster.
- Retail investor sentiment and general headlines (like the current trade war) have a huge influence on market movements, unlike western markets where clearer heads prevail at least for most of the time.

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<sup>4</sup> Contrary to popular perception however there is not academic evidence to back the claim fraud is more widespread in China than the US

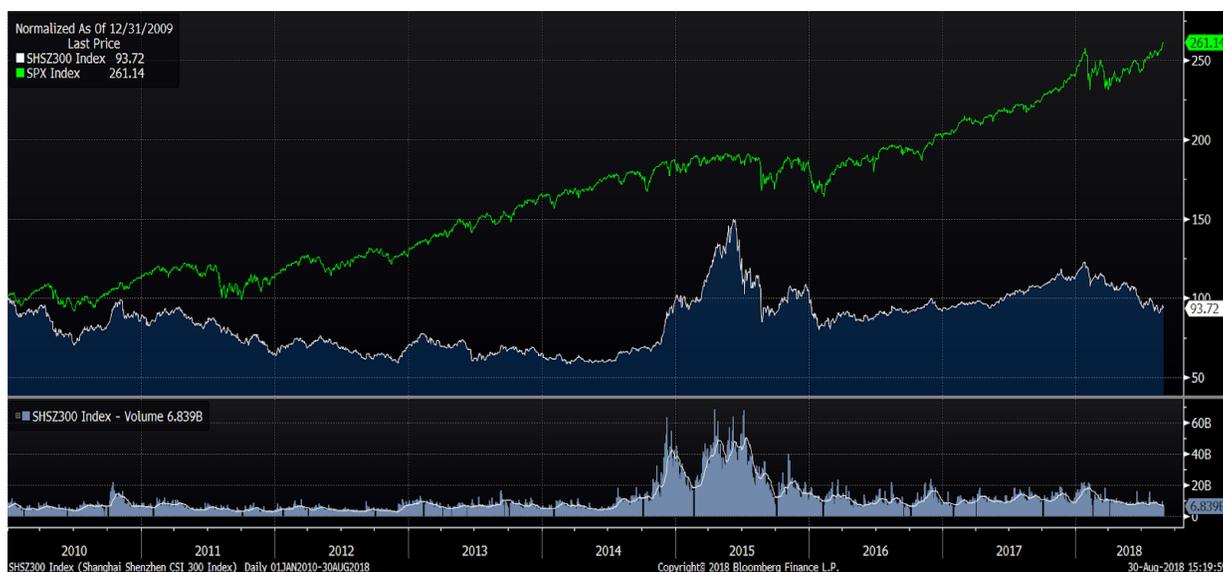


Chart: Shanghai Shenzhen 300 Index VS S&P 500, 2010-AUG 2018

One additional complicating factor: since the US still has the deepest and most sophisticated financial market, hundreds of Chinese companies, especially in the technology sector listed in New York instead of China. The problems arise because the investors base is in one part of the globe and the operations, most of the news flow and the users are in another and they sometimes don't speak each other's language<sup>5</sup>. This creates an incentive for simplification and a search for easy comparisons in the west for Chinese and Asian companies.

For example, Alibaba was once dubbed "China's Ebay" although its scale hugely surpasses anything seen in the US, Baidu was once known as "China's Google", Tantan as "China's Tinder" and so forth.

<sup>5</sup> As shown in sometimes comical conference calls where so much is lost in translation

But analogies only go so far. In the case of streaming, part of the low valuation, this house thinks, is derived from the fact that there are not listed peers in the US or European markets. This is really a Chinese phenomenon. And it led to an additional layer of discount and suspicion: China's news flow has been very bearish in the western press ( amazingly, the further away from China one goes the more bearish are the headlines), so US based investors put an extra premium for their lack of familiarity and understanding and for this suspicion, and on top of that there is a third level of discount because in this specific sector there are no western peers to compare and fall back to.

Very honestly, this house would be hard pressed to name an elite tech company in an emerging sector that has doubled its revenues in the past three years as YY has done and that trades as cheaply as it does.

YY 's current market cap is around 32 billion Yuan (around \$ 5 billion). Lower than many unprofitable "unicorns" we read about in the press on a daily basis. But even that is a bit illusory: the company has almost half its market cap in cash, with no outstanding debt.

Adjusting for this cash (while remembering the fact that some of it should still be used to additional stakes in Bigo) we would reach an adjusted market cap of around 21 billion yuan.

YY in Y\$	2015	2016	2017	2018 (e)
Sales	5.897	8.204	11.594	15.611
Ebitda	1.366	1.959	2.902	3.084
Net Earnings	1.124	1.444	2.432	3.225

## YY selected multiples (2018 consensus estimate)

Price to Sales Ratio	2,11
PE	10,24
EV Ebitda	7,10
Free Cash Flow Yield	8,28%

Next year, according to Bloomberg consensus, YY should record revenues of around Y\$ 16 billion, giving a price sales ratio of 2. Its earnings should fetch around 3 billion. Its forecast price earnings ratio (adjusted for cash) is 7, its EV Ebitda multiple is around 6.5. This for a company that grew its sales at a 46% annual clip over the past three years.

Obviously, no one is suggesting Netflix is a perfect comparison to YY. But it may be the most similar company in US markets. It also grew very fastly, around 28% per year over the past three years. Of course, Netflix has a far larger scale, with sales around 15 billion for 2019 (against YY's projected 2.2 billion dollar sales for the same year).

That being said, one could argue that YY is a younger company, that grows faster and located in a more promising market that should therefore enjoy higher multiples.

Company	P/S 2018	P/E 2018	FCF yield 2018
Netflix	10,23	102,0	Negative
YY	2,11	10,3	8,28%
Momo	4,55	17,5	6,14%

Well, Netflix enjoys a price to sales ratio of 10, an EV/Ebitda multiple of 80 and a PE ratio of 105 for 2019. YY enjoys a price sales ratio of 2, PE ratio of 7 and EV multiple of 6.5 with faster growth. As for free cash flow, it is

negative for Netflix while the consensus forecast for 2019 is that YY is selling for eight times its free cash flow for next year.

What about Momo? We think it is an apple to oranges comparison since Momo's premium seems to be related to the Tantan acquisition. We are skeptical: if internet history teaches us one thing is that you should be dominant in one sector: streaming, music, online dating, online retailing, internet search, etc. But no company has explored obvious and enduring synergies between unrelated internet services: Amazon still chases Netflix in streaming, Google failed in social networking, Apple failed in maps and information and Facebook will (this house thinks) fail in online dating.

We just don't see a lot of synergy between a desire for entertainment in the form of streaming and a desire for bonding in online dating. We may, of course, be proven wrong. But we wouldn't pay a premium for it. In fact, we suspect Tantan may be spinned off sometime in the future. Let's not forget that unlike the US where venture capitalists ran the show for decades, in china it is corporate venture capital and empire building by tech companies that has been the main act so far in tech M&A.

We think that YY, being the largest player in China's streaming industry, and also having two very compelling additional growth venues (e-sports through Huya and streaming in Southeast Asia and India with Bigo) should command a premium to Momo when the opposite is happening.

A final word on that: many investors are bullish in online dating in China and would love to have some exposure. We just don't think buying Momo is the right vehicle since Tantan is still a very small fraction of its revenues. We would wait for a spinoff as we mentioned above.

## 4 - Risks and the road ahead - Conclusion

Recently the world championship E-sports final in Katowice, Poland, made headlines by having a unique online viewership of 46 million people<sup>6</sup>. Most people wouldn't ever consider E-sports a serious event watched by someone who is not a teenage nerd, let alone put it on par with the Superbowl, but the fact is the tournament's viewership had an audience on par with Superbowls. So for many uninitiated, this must be puzzling and surprising.

Bit by bit e-sports are going mainstream. Generations change, and millennials grew up used to the idea of being online all the time. It is not written in stone that their pastimes will be similar to baby boomers, with their booze and pick ups. As Twitch CEO recently put it, if you love doing something you will inevitably enjoy watching someone that is really good at that doing it. To put it in other words, if you enjoy playing tennis, it is hard not to love watching, say Roger Federer or Rafael Nadal play. If, on the other hand you enjoy playing Dotta, like millions of young adults around the world do, many of them will flock to watch the world's best Dotta players battle each other in E-tournaments.

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<sup>6</sup> <https://www.forbes.com/sites/paularmstrongtech/2017/03/16/46-million-watched-live-esports-event-10-million-more-than-trump-inauguration-broadcast/#64dd95de91f4>



League of Legends world tournament



Team One: a brave new world

Likewise, a young generation of Chinese will seek refuge in new and inventive ways. They have material comfort that their countryside elderly parents could only dream of but still not rich by western standards.

In a recent interview, Momo's CEO mentioned the fact that probably 75% of the world singles live in Asia. And for most of them this situation is not by intent due to the China's and India's skewed sex ratio because of widespread female fetus's abortion a couple of decades back.

Meanwhile, the region has witnessed an influx of hundreds of millions of people from the agrarian fields to the city. They live away from their friends, families and their social circles.

To sum it up: Asia is probably home to most of the loneliest people in the world, especially in the case of people in their 20s and 30s.

Online streaming offers refuge, in a similar way, suburban baby boomers in the 1950s and 1960s in the USA sought refuge on television. It is affordable for their incomes, it helps them fight their loneliness (in streaming case by interaction and having attention of their hosts) it suits Asian shy culture and it fits like a glove for a country that is urbanizing and gaining access to broadband network at a scale unseen so far in this planet.

What could go wrong?

- Streaming could fail in gaining acceptance, be proven a fad or suffer with heavy regulations.

We certainly agree this risk is not zero, but it seems to us completely contrary to real world evidence so far.

It is true that there are ever more entertainment options for middle class Chinese consumers but that has been the reality for emerging consumers since capitalism was invented.

If we analyze both YY and Momo as well and their smaller competitors, the opposite is happening: all of them are gaining MAUs (monthly average users) at a rapid clip.

MAU (Millions)	2016	2018	30/jun/18
YY	56,1	76,5	80,2
Momo	81,1	99,1	108,0

Note: Momo has more users because of its social networking functions but YY has a higher number of streaming viewers and paying streaming viewers.

- Momo or some other entrant could become the prominent force in Chinese streaming and YY could decline.

Again, this is not impossible, and this possibility seems super hyped by the investment community. The market seems to have decided that due to some amazing and unforeseen synergies with Tantan, Momo will inevitably surpass YY. Or that Tencent will, with the snap of a finger displace the company that has been building and leading this industry for the past 13 years.

But again, to the facts: YY is still the number 1 force in the industry, with higher MAUs, annual revenues and average user engagement than Momo or any other player. And that is even before accounting for the fact that YY has amazing optionalities with Huya (a subsidiary also listed on the Nasdaq and focused on E-sports) and Bigo (focused on live streaming for India and Southeast Asia).

This house thinks Momo is an amazing company and we do think both of them will thrive. Some artists guilds will prefer working with one over the other and that's fine. The important fact is that the sector is oligopolizing and a few dominant players will emerge. We think both have a great future ahead.

- China could crash.

Finally, there is the possibility of a Chinese economic collapse. Even if that happens, we think streaming would keep growing: it is more affordable than, say, eating out and people are not going back to cave age.

That being said, it is interesting to note that China has already emerged: it already has a scale of consumption that in many areas matches and even surpasses American and European levels. Our bet is that gradually, consumption in China, India and Southeast Asia will keep growing quicker than the US and Europe because there is still a lot of catching up to do.

To summarize, we see traits of a winning company in YY. First, it is certainly not obvious. But then again, Netflix was a favorite short by many during the early 2000s: high multiples, a rising champion of an unproven industry and a bet that consumers would fundamentally change their habits. YY has all those characteristics except for the high multiples.

Also, it is something new, exotic (for western investors) and that raises suspicion. We see the ingredients of something cheaper than it should be. And we see passionate consumers and a new community of users in a growing middle-class society around the company.

## Sobre a FCL Capital

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