

# RF Capital Management LLC

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Dear Investors,

Year-to-date through the end of July, RF Capital has returned +34.93%<sup>1</sup> net of all fees. In comparison, the S&P 500, Russell 2000, and MSCI ACWI generated returns of +19.52%, +14.67%, and +18.30%, respectively, over the same period. Please check your individual statements for your exact returns.

Our portfolio currently has 17 holdings and a 23.65% cash position. Going forward, we hope to reduce the cash position. However, the cash position is dictated by the opportunities available, and we set a high bar for investments. We prefer to hold cash for the optionality and dry powder rather than be 100% invested at all times. The cash drag doesn't bother us, and it certainly hasn't impacted our returns negatively.

In this letter, we will discuss our firm's performance and provide brief commentary on Zengame Technology. Next, we will provide an operational update and our market outlook for the rest of the year.

## OUR PERFORMANCE

As we approach our sixth year of operation since inception, a bird's eye view of our performance<sup>2</sup> is in order. Here's how we have done versus the markets:

	<b>YTD</b>	<b>1 YEAR<sup>2</sup></b>	<b>3 YEAR<sup>2</sup></b>	<b>5 YEAR<sup>2</sup></b>
RF Capital	+34.93%	+36.84%	+31.36%	+15.17%
S&P 500	+19.52%	+11.11%	+12.23%	+10.66%
Russell 2000	+14.67%	+7.86%	+11.61%	+6.55%
MSCI ACWI	+18.30%	+12.65%	+10.38%	+8.49%

Overall, we are quite pleased with our firm's performance since inception. Given that we run a concentrated portfolio and employ minimal to no leverage and shorting, our returns are even better on a risk-adjusted basis. Furthermore, we tend to have a high cash position – anywhere from 10% to 50% of the portfolio if we can't find anything to buy.

Over the last three years, we really hit our stride as an investment manager. Notably, our absolute and relative performance got stronger as the years went by since inception. This was not

<sup>1</sup> RF Capital returns are calculated on a composite basis. Individual returns may vary based on the timing of investment and the fee schedule. Past performance is not indicative of future results.

<sup>2</sup> Returns are calculated on an annualized basis.

a pure coincidence. It took some time to settle in as a full-time, professional fund manager. As we figured out what investments worked in the current market environment that also fit within our circle of expertise, the better our hit rate and returns became. Also, the portfolio just needed time to breathe. Our favorite holdings tend to require several years before the gap to intrinsic value is closed.

Furthermore, we got off to a slow start in our first two years of business due to many of our initial investments being skewed towards the deep value and distressed categories. In those years, deep value as a broad category did not perform well. (For example, many value fund managers lost money and underperformed the markets during that period of time.)

However, as the years went on, more and more of our investments fell into the “hypergrowth,” “high-quality,” and “GARP” categories. Despite the business quality of our holdings improving over time, we have always paid “value investor” prices for our portfolio companies.

Other than the different types of investments made, significant changes that contributed to outperformance in recent years and the transition to “RF Capital 2.0” (which occurred around 2020/2021) include focusing on nano/micro/small caps, investing in foreign countries, and trading around positions.

Small companies have always made up the bulk of our portfolio. However, we had more mid/large caps in our portfolio in the earlier years. Now, we focus more on nano caps (<\$100M market cap) and micro caps (<\$500M market cap) in our search process. To a lesser extent, we also look at small caps (<\$2B market cap). The reason isn’t that mid/large cap companies are off limits to our firm. We have just historically had more success finding multi-baggers in smaller companies. We would like to increase our odds of finding more multi-baggers in the future, which in turn would increase our annualized returns. Also, our firm’s size allows us to be nimble and invest in the most inefficient pockets of the markets.

We have also been successful in investing in foreign companies. Investing in other countries has expanded our opportunity set and provided us with more options in our quest for value. Other countries that we have invested in recently include Australia, Hong Kong, Japan, and Singapore.

Our approach to trading around positions was also a game changer. To be fair, our portfolio activity is still minimal. (Our investors who login to their client portals weekly and monthly often note that the portfolio looks the same with few changes.) We simply changed the way we entered, exited, trimmed, and added to our positions. In the past, we were strict value investors and held positions for the long-term until intrinsic value was realized. We would also buy and sell all at once most of the time. Nowadays, we trade around positions based on the price action. Also, we use charts and technical analysis to provide signals for when to buy, sell, add, and trim. We still invest in companies for the long term. We just aren’t as rigid with trading around positions as most value investors are. We have found that our fluid trading framework has helped us manage downside risk much better while capturing both short and medium-term upside. The long term always takes care of itself as long as we follow core value investment principles.

Going forward, we think our best years are most likely ahead of us. Despite all of the mistakes and initial inexperience as a professional money manager, we have survived the past 5.75 years – with market-beating performance to boot. And yet, we are still developing and learning as investors every single day. We hope to make another huge leap and reach “RF Capital 3.0” some day in the near future.

## **ZENGAME TECHNOLOGY (2660.HK)**

Judging by the price action in late March, investors weren’t expecting huge numbers to be reported. After earnings were released, most investors were probably disappointed. Zengame’s stock price has fluctuated between HKD\$3.00/share and HKD\$4.30/share the past few months. The volatility is somewhat strange (but not unusual for a microcap) given the lack of material events other than earnings in March and the cash dividend and annual meeting in June.

As with most investments, beauty is in the eye of the beholder. For us, any company that grows its revenues and earnings in excess of 20% is an excellent company to own. (Zengame did just that in the most recent half-year period.) However, most sell-side and buy-side investors that have positions in Zengame seem to expect growth in excess of 50% or 100%. Therein lies one of the reasons why the company continues to remain cheap at 2.38x EV/EBIT and 4.36x P/E.

Understandably, the reported numbers were underwhelming for investors seeking 50%+ growth rates. In our view, the reported YoY numbers were still quite strong. Revenues, gross profit, profit, EPS, and the final dividend grew by 19.9%, 25.7%, 36%, 38.8%, and 40%, respectively.

Furthermore, there were increases across several revenue-generating metrics. Revenue from sales of virtual items increased 47.8%, MPU for virtual items increased 6.73%, and ARPPU increased 51.14%. Board games revenue also increased approximately 60.7%. While other KPIs were disappointing and showed decline, we have always believed that growing revenues and earnings to be the most important things for the company’s long-term success. Increasing the number of players, MAU, DAU, and etc. is great. (We would certainly applaud the company for doing so.) But all of that is meaningless if the company can’t convert those new users into dollars for the company’s bottom line.

Certainly, it’s worth noting the decline in several KPIs. For example, MAU and DAU decreased 16.81% and 15.67%, respectively. While we would prefer to see growth in active users, what matters more to us is ARPPU. Going forward, we will continue to monitor KPIs like MAU and DAU with a close eye because these figures do matter. However, these metrics must be viewed in conjunction with ARRPU. A company that boasts the most users in their niche, but can’t turn a profit, is still an undesirable company to own in our view.

Furthermore, numbers across the board for card games and the in-game information service decreased. Normally, we would be concerned if we viewed those numbers on a standalone basis. However, the 47.6% decline for the in-game information service is actually a positive development. Less ads means the overall game experience is enhanced. (Apps or games that are oversaturated with ads and destroy the overall user experience will remain nameless.) As long as

ARPPU continues its high-growth trajectory, the decrease in in-game information service will be balanced out.

For the decline in card games, it's just a matter of game cyclicity. Mahjong is currently the company's flagship and most popular game, so it only makes sense that all other games aren't performing as well in terms of numbers. Over the next two to five years, it could be another new board game or card game that dominates and drives the company's earnings. The Chinese mobile game market and its users will dictate. So it's important to view both increases and decreases in HoH figures as a whole rather than panicking about a large decline in one particular segment. Investing in general is all about context.

The decrease in revenues and user scale of China's mobile game market is also worth monitoring going forward. Per the 2022 China game Industry Report, China's mobile game market sales decreased 14.4%. Negative market trends are always a yellow/red flag to watch out for. It partially explains why growth rates have declined significantly this HoH period compared to the previous two periods. Thus, it's important to monitor this company for faltering growth going forward over the next couple of years. Luckily, the company is so cheap on multiple valuation metrics that a decline is already priced in.

Nevertheless, we believe the company is on the right trajectory going forward. Fingertip Sichuan Mahjong ranked first in card and board games on the iOS bestseller list. This is a recurring trend for Zengame's flagship game - no matter which one it is. The game(s) that Zengame focuses on in terms of marketing and R&D tends to perform well on the bestseller's list and is popular amongst players and live streamers. Furthermore, Zengame's management team has placed an emphasis on expanding and growing via the overseas game market. Two overseas games were launched in 2022. While material success of overseas games remains to be seen, it's great to see management thinking about and executing on other growth avenues for the business. An increase in the number of players also improves the probability that ARPPU continues to grow.

On balance, Zengame continues to be one of our favorite holdings. As long as the company continues to increase the number of users and sales of in-game items, the return on our investment will be quite satisfactory going forward.

The company is currently a 24.79% position in our portfolio. As a reminder, our initial average cost basis was HKD\$1.15/share. For new inflows of capital, the cost basis increased slightly due to the price action. However, all our investors have a minimum unrealized gain of more than 2X on the investment in a relatively short period of time.

## **OPERATIONAL UPDATE**

In mid-May last year, we welcomed Arman Motahar to RF Capital as a Summer Investment Analyst. He helped us generate new ideas, conduct primary due diligence, and value companies with detailed DCF models.

Arman just finished interning at Permian Investment Partners, a long/short hedge fund in Dallas. Next summer, he will be joining PIMCO as an alternative credit summer analyst within the

special situations team in New York. Previously, he had internship experience at the U.S Securities & Exchange Commission where he was responsible for research. He is currently a junior at the University of Texas at Austin pursuing a degree in finance.

Arman completed his internship with our firm and was an excellent addition to our team. We initiated several new positions in micro-cap companies that he recommended. Additionally, he helped us conduct primary research on our portfolio companies, which helped us considerably with our maintenance due diligence process.

Additionally, we completed our fifth year of operation as an investment firm in October 2022 as mentioned above. We would just like to thank our Day One investors and each and every one of you who joined us along the way. It's never an easy decision to invest with an unproven, emerging manager. So we really appreciate all of you for your trust and continued support. While it may sound cliché, we truly believe that we have the best investment partners a fund manager could hope for.

Currently, the fund is open to new investors. We would greatly appreciate it if you could refer any friends or acquaintances that may be interested in investing. The minimum is \$500,000. (However, we are willing to accept a lower initial investment as long as they are the right fit and are willing to increase their account value to the minimum over time.)

## **OUTLOOK**

Now is the time to be conservative. It's not the time to play offense. All signs point to a recession. Multiple indicators signal a weakening and deteriorating economy. And yet, the markets haven't reflected it. Except for a few pullbacks like in the month of March, the markets have directionally gone up in price. Perhaps we are in our own echo chamber of like-minded peers and investors, but it seems like anyone and everyone is expecting a recession and a market crash some time within the next few quarters. Whether the markets continue to rally despite common knowledge remains to be seen.

Regardless, we are well-positioned to take advantage of rising or declining markets. If the markets continue to go up, we'll stay disciplined – swinging only when investments meet all of our criteria. We'll also focus on hypergrowth and high-quality/FCF-generative companies. If the markets start crashing, we may go on a buying spree as companies become dislocated and undervalued. We would then focus more on deep value type companies. Either way, we are looking forward to closing out the year and completing our sixth year of operation.

Thank you for your support, continued interest, and referrals. Please email me at [roger.fan@rfcapitalmanagement.com](mailto:roger.fan@rfcapitalmanagement.com) if you have any questions, concerns, or comments.

Best regards,

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