FSSA INVESTMENT MANAGERS

Global Emerging Markets Equities

In 2020, one group of companies has done particularly well – the popular digital technology companies focused on e-commerce, delivery and entertainment, to name a few industries. In emerging markets, they dominate the Chinese market; but they can also be found in Korea, Southeast Asia, Eastern Europe and Latin America. We do not own many of these in the strategy; and as such, we are often asked: What holds us back? After all, they have performed well and – at least on paper – should have the prerequisite to generate strong returns and free cash flow, given their often high gross margins, negative working capital profiles and asset light nature. While we are not disputing the potential for this in the future, we would argue for cautiousness on most of these projections.

Growth Traps?

In the investment world, "value trap" is often used to refer to a company that is statistically cheap (either in the form of a low price-to-earnings (PE) or price-to-book (PB) ratio), but has the misfortune of being loaded with deteriorating fundamentals. The optical bargain attracts investors, yet the weak operational performance hinders any meaningful share price gains and the company continues to underperform to the great frustration of its investors.

While many of today's popular digital technology companies are regarded as almost the exact opposite of a value trap, with their high valuations and seemingly strong fundamentals, we would generally treat the projections underpinning these assumptions with caution. Understanding the economic characteristics of a business is different to predicting whether an industry is going to grow. Just as value traps fail to sustainably increase the underlying value of their business, could many of today's popular digital technology companies face a similar destiny?

The business model of most digital technology companies is centred around re-distributing trade, advertising and other services from offline to online. While this can be significantly disruptive for traditional offline retailers, media formats and the like, it is not clear to us what the longer-term returns will look like for the digital technology companies themselves. The fundamental problem as we see it is that many internet/e-commerce industries have fairly low barriers to entry and low marginal costs, which attracts competition and thus prevents the dominating companies from keeping the profit pool they are attacking.

For instance, over the past 12 months the combined free cash flow generated before investments by the five largest digital technology companies in emerging markets (Alibaba, Tencent, Meituan, JD.com and Pinduoduo) amounted to USD50bn, or 2.5% of their current market capitalisation. At that run rate, it would take the group 40 years to return its current market capitalisation from the free cash flow it is generating, or more than twice the length of time of the average emerging market company. In other words, investors are betting massively that the free cash flow growth rate of this group will pick up significantly in the coming years. But, is this realistic?

Huge user bases and astonishing transaction numbers are often cited as evidence of customer engagement and a brand. However, what has happened is that digital technology companies have taken market share from existing channels and transferred the profit pool to end customers (consumer surplus). The hope is that when sufficient scale has been attained, these customers can be monetised and would generate high profit margins for these companies, given that their own costs and capital expenses tend to be lower than for traditional channels. But, we are starting to see evidence that this is easier said than done, as competitive pressure builds up across digital sectors (particularly e-commerce and food delivery, to name just a few).*

The notable pace in which Alibaba has lost market share to rival Pinduoduo underscores this point. Over the last 12 months, Pinduoduo (which was only founded five years ago and has been loss-making every year) has reported an astonishing active user base of 731mn, rivalling that of the

* For illustrative purposes only. Reference to the names of each company mentioned in this communication is merely for explaining the investment strategy and FSSA Investment Managers does not necessarily maintain positions in such companies. Any fund or stock mentioned in this presentation does not constitute any offer or inducement to enter into any investment activity nor is it a recommendation to purchase or sell any security.

established leader, Alibaba (757mn), which was founded more than 20 years ago. We have seen similar dynamics play out in the Chinese online travel booking industry, with incumbent C-Trip (now renamed to Trip.com) constantly finding itself in a price war with yet another new entrant, Meituan, just as it was about to raise its commission rates. This trend is not limited to China either – we have seen similar tactics used by Shopee against Lazada in Southeast Asia, as well as B2W and Magazina Luiza against Mercado Libre in Brazil. In other words, disruptors have turned end customers and merchants into deal-seekers with little loyalty to any company – and thus with limited ability to be monetised. This is the definition of a commoditised industry, in our opinion.

There are a few exceptions, such as vertically integrated companies or companies benefitting from real network effects (i.e. a winner-takes-all situation). But, again, the outlook is not straightforward. Where companies have tried to integrate vertically by raising their value added (for example, by offering distribution and logistics services), their offerings have come at the expense of higher asset intensity, which again lowers returns. And for companies benefitting from network effects, anti-trust regulation is a real concern. A pertinent example is that of Ant Financial, almost the biggest IPO ever. Chinese regulators took the extreme step of pulling the IPO and forcing a massive change in the company's business model, which made it significantly less attractive to investors. The reining in of Tencent via the establishment of a gaming regulator in 2018 is another example. We would not be surprised if additional measures follow for other players, such as regulations around the employment of temporary workers and rules around the "gig economy" that many freelancers are discovering to be quite exploitative.

While we have no doubt that some of these digital technology companies' business models will eventually emerge as sustainable, investors globally are currently rewarding most with a valuation premium that signals long-term sustainable growth and returns. Though times are certainly different today compared to the dot.com era and the Nifty Fifty boom during the late 1960s/early 70s (*"the only rule is to buy"*), the current situation may turn out to be not so different. In both of these historical instances, investors who bought "at any valuation" subsequently found themselves at a loss. Indeed, investors who bought a basket of the so-called Nifty Fifty stocks at their peak in 1972 had to wait nearly two decades to break even. It took 17 years before investors in Microsoft broke even on their December 1999 entry price. Similarly, Amazon fell an incredible 95% from its December 1999 peak; it was 2009 that investors broke even on that investment. Both of these companies boast phenomenal franchises and exceptional management teams; and yet, even *they* met with such a fate.

Management teams at today's popular digital technology companies are on an ever-accelerating treadmill that they cannot afford to slow down. If they do, there is always someone behind them ready to take their spot. Growth at any price has become the new management mantra for this cohort, as we were reminded in a recent meeting with a loss-making Latin American e-commerce giant. When asked about the prospect of focusing on margins and profitability, the management casually remarked, *"We are very much aware that investors value us on a sales multiple."* Implying that the trade-off between growth and profitability is very real.

Similar to how value traps fail to increase the underlying value of their business, we believe many popular digital technology companies will face a similar destiny. The absence of any meaningful free cash flow makes us cautious and we believe investors are setting themselves up for another kind of trap, attracted by strong growth rates, but with equally unattractive characteristics for long-term investors.

Portfolio Update

In our last update in May 2020, we discussed the reasons we remained positive on the financials and travel-related companies in the portfolio, despite the near-term headwinds caused by the pandemic. At the time of writing, many excellent companies (which had navigated and survived the debt crisis of the 1990s and the global financial crisis (GFC) a little over a decade ago) had fallen to levels that almost signalled extinction. However, as we argued back then, we believe the structural investment case is set to improve for many of our holdings in the coming years. For the banks, we argued that their strong capital position combined with an improving competitive outlook (as weaker players would continue to struggle) would set them up for a faster recovery and likely higher levels of profitability on the other side of the pandemic. For the travel-related companies, we argued that in addition to the improved competitive outlook, the strong focus on cost reduction would ensure much improved operational leverage once demand comes back, and thus a strong bounce in margins and profitability could be expected.

Another industry that should benefit from operational leverage once demand comes back is the restaurant sector. We have previously discussed our other holdings in these letters; and, since our last update, we have added another restaurant operator to the portfolio.

A leading quick service restaurant brand in the Philippines

This company is a leading quick service restaurant (QSR) brand in the attractive, fast-growing Philippine market. In addition to the main brand, it also operates a number of other brands domestically, while internationally, it operates franchises in Vietnam, China, other countries across Asia and the US.

We have known and monitored the company for a number of years and have always been impressed by the operational capabilities of the senior management team, headed by the current CEO who was appointed in 2014. The company dates back to 1975, when the founding family in Cubao, Quezon, established it as an ice cream parlour. Shortly after, the company started serving hot meals and sandwiches, which became so popular that the family decided to convert the parlours into quick service restaurants and rename them to their current name. Since then, the brand has grown significantly and is today the largest restaurant company in the Philippines. With more than 3,000 restaurants and a 55% market share (roughly twice the market share of its three largest competitors combined), this restaurant brand is a strong market leader.

Similar to our two other restaurant holdings, the size of its operations relative to peers gives it a significant competitive advantage (in the form of leverage over suppliers and landlords) in addition to its sizable infrastructure advantage. More importantly, the company owns and operates the majority of its stores, which ensures a more consistent offering and allows it to extend greater quality control on matters such as user experience and food safety, which are critical to sustain customer loyalty in the industry. As pioneers in the domestic restaurant sector, it has spent decades building a strong moat that is difficult for any rival to challenge.

Unsurprisingly, these advantages are reflected in its margins and profitability. Its domestic earnings before interest and taxation (EBIT) margins at the store level are among the highest globally at 16%. And, given its favourable working capital cycle (the company receives cash upfront from its customers but pays suppliers with a lag), the company has been able to cover most of its capital expenditure and store expansion program from internally-generated cash. With the impact of the pandemic earlier in the year and the share price subsequently falling, we saw an opportunity to initiate a position. While the company posted losses on a cash basis in the second quarter, the company returned to cash profit in the third quarter of this year. Additionally, in a recent meeting, the management team revealed a substantial cost reduction program, which the company believes could boost sustainable profit on a per-store basis by 15-20% compared to pre-Covid levels. This is even excluding the turnaround of some of its recently acquired overseas brands, where investments/restructuring costs have been frontloaded and set to decline in the coming years.

The outcome of all these changes is that profitability is set to increase substantially from operational leverage as lockdowns are relaxed. The runway for growth also remains long with the market remaining underpenetrated. For instance, the company is only present in 11% of cities in the Philippines (the management believe they can be profitable in 20% of them); and in Vietnam, the largest restaurant operator has only 350 stores compared to the 1,100 branded stores this company has in the Philippines. In other words, the company is still in the early stages of growth in its core markets, which should support solid cash flow growth for many years to come.

General Insurance

Another area where we felt the market was overly negative on the impact from the pandemic is general insurance. This prompted us to take a closer look at the sector over the past eight months, resulting in two investments being initiated. One is a general insurance company in India and the other more recent investment is in Mexico. We think that the combination of strong management teams and attractive market positions in countries with significant long-term growth opportunities makes for a particularly powerful combination.

Our research indicates that successful franchises in this industry tend to share a few characteristics. Firstly, they are leaders in one or more business lines (usually auto or health insurance). Secondly, their competitive advantage stems from NOT doing certain things and selecting risks very carefully. Almost always, we have found that successful companies have astute management teams that think counter-cyclically and are prepared to walk away from underwriting risks that might present short-term gains but result in a disproportionately large longer-term loss. Finally, they tend to invest their float prudently. The investment float is a valuable asset in countries where interest rates are still attractive in nominal and real terms (and likely to remain so for the foreseeable future). The best franchises choose to let the wonder of compounding do the heavy lifting, instead of trying to take on higher risks by investing in lower quality companies or in timing the market.

A general insurance company in India

Established in 2001, our general insurance addition in India is a relatively young company. Starting as a joint venture between an Indian bank and a financial holding company,

this insurer quickly became the largest private player after the insurance industry opened to the private sector in 2000. Initially helped by the bank's brand, the company established an early lead in building relationships with Auto Original Equipment Manufacturers (Auto OEMs) and their dealer networks to sell the company's policies. The company became less reliant on the bank (only 7% of sales today) and the financial holding company subsequently exited the business – yet the franchise remains as successful and profitable as before, thanks to its established relationships, distribution reach and brand. These moats have helped this Indian insurer maintain its lead as the largest private player in the insurance industry with 7% market share today.

The company has outperformed the industry in terms of the Combined Ratio[1] by nearly 1000 basis points (bps) over the past decade (currently at 99%), suggesting a strong ability in risk selection and underwriting control. This is critical for general insurers as the service itself is somewhat commoditised – most customers are indifferent between a set of providers and will typically choose one based on price. Management thus have to pick their battles very carefully and we think this company does this very well. There is a clear line of what they simply will and will not do. For example:

- Over the history of investing their float (20 years now), they have not faced a single instance of delayed interest payments from their fixed income portfolio (let alone defaults). They have had zero exposure to the various corporate bankruptcies that have surfaced in recent times. By contrast, most peers have had to write off losses in these accounts. Similarly, in their equity portfolio, they have generated returns of over 22% compound annual growth rate (CAGR), mainly by backing high quality franchises and avoiding mistakes.
- Early on in their history, the management had to face a chaotic dismantling of the regulated pricing regime (or de-tariffication). Their response was to slam the brakes on growth and focus on profits. Many of their peers continued to grow, fighting for market share, and reported large losses in the process. We were struck by this contrarian behaviour for what was then a six-year old organisation. From 2002 to 2007, it had grown at a scarcely believable 154% CAGR; over the next three years, it grew by just 7% CAGR!
- They have always been ahead of the curve with respect to setting reserves, and were the first to disclose their reserving process and numbers transparently. They have now reported nine consecutive years of reserve redundancies (by reserving slightly more than needed).
- They have demonstrated the ability to walk away from large industry segments, with no regard for their overall market share. Recently, they decided to stop underwriting crop insurance, which was as much as 17% of their revenue in fiscal year (FY)20 – a bold decision to make.

Non-life insurance premiums per capita in India at USD18 is one of the lowest in emerging markets, and compares to USD185 in China and USD2,000+ in most developed markets. In other words, we believe that the industry tailwinds in India should pan out over multiple decades. With one of the strongest management teams we have come across, a solid long-term outlook for the industry, and a compounding investment float to amplify the strength of the underlying franchise, we believe this Indian insurance company should generate attractive returns for shareholders over the long term.

A Mexican auto insurance company

The other new addition is a leading Mexican auto insurance company with over 30% market share (more than twice the size of the #2 player). It has compounded earnings at 32% CAGR over the past decade, with an average return on equity (ROE) of 27% over that entire period. Over the past decade, its Combined Ratio has averaged 92%, which reflects a very profitable franchise. 92% of sales come from Mexico (30% market share), 4.8% from the US (they do not target operations in the domestic US market, but the commercial vehicles that frequently cross the border), and the remainder from Costa Rica (8% market share), Peru (2.5% share) and El Salvador (8.5% share). They operate via a network of 200 service offices and 260+ development offices across Mexico. These are owned and managed by franchisees. They also have 16,300 non-exclusive agents who are the mainstay of the business (60% of sales).

Like in the case of the Indian insurance holding, the management team of this company is highly risk-aware and focused on profits. They operate solely in the auto insurance segment and dominate it. They incentivise the whole organisation and even their agents on the basis of loss ratios and not premium growth – as a result, every layer of management is focused on selling the right type of policy at good prices, rather than chasing market share.

Over time, the company intends to diversify into other segments, such as health insurance. We believe the management will succeed in gaining substantial market share, which would help maintain growth over the medium term, especially as the Mexican non-life insurance market – like India – is still vastly underpenetrated with premiums at USD116 per capita. In addition, they have spent the past

[1] The Combined Ratio is a measure of profitability based on an insurance company's daily operations (and not from investment income)

decade studying the market in neighbouring countries and now feel confident about accelerating growth there (currently 8% of sales). In our view, this combination of excellent stewardship, a strong franchise and good future growth prospects makes this company an attractive long-term investment opportunity.

Outlook

2020 has been a challenging year for the strategy, but we remain confident about the long-term prospects of the businesses we own. Our holdings are market leaders in attractive categories with significant competitive advantages, which allow them to generate strong cash flows. Furthermore, they have plenty of scope to grow in the coming 3-5 years and are led by excellent stewards, thus making them ideally positioned to weather a crisis. Whether these encouraging bottom-up fundamentals will be reflected in their share price performance in the coming years is anyone's guess, but we remain as confident as ever in our portfolio holdings' ability to deliver solid long-term results.

In this letter, we have tried to cover points that we thought might be of interest to the strategy's investors. If there are any questions or feedback concerning the strategy, our approach or operations, we would welcome hearing from you. Thank you for your support.

Source: Company data retrieved from company annual reports or other such investor reports. As at 30 November 2020.