FSSA Investment Managers

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Quarterly Manager Views

FSSA Global Emerging Markets Equities Focus

> "Show me the incentives and I'll show you the outcome."
>
> Charlie Munger

In almost every meeting that we have with management teams, we will ask about incentivisation. In our view, it is an important question and the answer can be highly revealing about an organisation's culture and behaviour. While it can be easy to be deceived by articulate CEOs talking up a big game with lots of investor-friendly buzzwords, in our experience what ultimately drives outcomes (at least the ones that management teams can influence) are the incentives.

As with most things, striking the right balance is key. If there are no incentives to good performance (and no disincentive for poor performance), companies often end up with capital being systematically mis-allocated without any accountability. This tends to be the case with most State-Owned Enterprises (SOEs), which is one of the reasons we are generally cautious on them. On the other hand, too much of a good thing can also have adverse consequences, which we often see in turbo-charged incentive schemes concentrated among just a few senior executives. While they might lead to exponential growth for a short period of time, the growth is usually not sustainable. After a rapid period of expansion, imbalances are typically built up and when growth inevitably slows it is usually not just one skeleton that falls out of the closet.

In previous letters, we have highlighted the characteristics of companies we have termed "Growth Traps". One common feature of these companies is the extent to which they use Share-Based Compensation (SBC) to reward employees. Given that they are usually loss-making and their fuzzy business models emphasise growth above all else (in terms of users, sales, etc.), it is only natural that they seek to use stock (a non-cash item) to compensate employees. Over the past few years, share prices of Growth Traps have risen exponentially, and employees have benefitted massively (and in some cases — arguably — also at the expense of shareholders).

As we analysed the Top 25 most unprofitable companies in Emerging Markets (by measure of cumulative net income/losses over the past three years, adjusted for sectors like Airlines that sustained one-off losses due to the pandemic), we found the numbers staggering. Over the calendar years 2018-20, this set of companies reported a cumulative loss of USD 80bn and paid USD 6.3bn in SBC to their employees over the same period. Their SBC amounted to USD 13 for every USD 100 of sales, with some egregious "pre-revenue" bio-tech companies paying as much as USD 200 of SBC for every USD 100 of sales. By comparison, among the companies in our portfolio that offered stock incentives, SBC as a percentage of revenue averaged a healthy 0.8% over the last five years.

Given the share-price correction of many such companies in recent months, we believe there are serious second-order effects lurking in the shadows of companies where SBC was a large proportion of overall cost. Firstly, we note the significant wealth destruction for employees. They are now "out of the money".[1] More importantly, the dilution in shares outstanding on account of SBC becomes untenable if these companies attempt to keep the absolute amount of stock compensation roughly similar vs. previous years. So, in addition to poor employee morale, they are likely having to deal with high attrition in the medium term.

[1] A financial term indicating that the share-based compensation, which requires the share price to reach a certain level, is not currently worth any monetary value.

All this is not to say that we are against stock-based incentives. We are, in fact, strong proponents of stock ownership across all levels of the organisation. When incentives are designed properly, with all stakeholders in mind, the outcomes are wonderful.

That is why we often encourage board members and management teams to think about assigning key performance indicators (KPIs) on the right metrics. For example, while sales growth is critical and forms a large portion of any incentive scheme, we also believe that linking it with return on invested capital (ROIC) and free cash flow (FCF) generation adds the necessary guardrails to ensure that only the right kind of growth is rewarded. Furthermore, we dislike incentive schemes that are focused on the near term. We prefer schemes that encourage managers to take a long-term view (typically five years or so). Finally, we believe that employee share-option plans (ESOPs) work best when a significant proportion of the senior and middle management are included, rather than just a handful of CXOs.[2]

Another concern relates to excessively complex incentive schemes. The longer the Remuneration Report, the more worried we get. These days, it is hard enough keeping up with "adjusted EBITDA"[3] and other non-GAAP[4] measures. Throw in complex calculations of Relative Total Shareholder Returns, percentile rankings provided by conflicted third-party benchmarking firms and we wonder if even the CEO knows what he or she needs to achieve. In fact, many we have asked don't!

Some of the best incentive schemes are the simplest ones — for example, we came across a Chinese medical implant manufacturer (which we ended up not investing in, but for other reasons rather than incentives) where the management had instituted an ESOP for the first time in the company's history. The scheme was valid for 10 years, wherein the vesting conditions were simply that every year the company achieved 35% year-on-year sales growth AND 25% year-on-year profit after tax (PAT) growth, but excluding mergers and acquisitions (M&A), then 25% of the SBC grant is paid out (a maximum of four times during the validity of the scheme). Whilst not perfect, we believe the scheme is a good first attempt.

Similarly, Sandeep Bakhshi, who became CEO of ICICI Bank in 2019 (one of the top holdings in our strategy), simplified the incentive scheme massively, cutting down the number of KPIs from 18 to just two: 20% growth in Pre-Provision Operating Profit (PPOP) and credit costs to be contained within 20% of the PPOP (equating to around 0.5% of assets). This breaks down silos between various parts of the Bank and encourages the organisation to pull together in one direction. The results have been terrific, with all aspects of the Bank's operation showing significant improvement — a simple but significant change that has been well reflected in the share-price performance.

Increasingly, incentive schemes are starting to include parameters relating to environmental, social and governance (ESG) factors, which we welcome. However, we are wary of the overly quantitative, box-ticking methodologies that seem to be in vogue these days. We do not want to see management give up 18 KPIs only to add back 16 additional ESG KPIs. In our view, the ESG-related incentive scheme at Korean company Naver is a good example of one that has been structured well. Naver recently came under scrutiny for poor corporate culture after an employee committed suicide, allegedly owing to extreme work pressure. We have engaged with the company on this issue and there have been a number of positive outcomes, the first being a change in leadership, as the new CEO (Ms Choi Soo-Yeon) has been tasked to achieve a "healthy organisational culture" as part of her KPIs. The company then introduced a complete overhaul of corporate practices, ranging from hiring processes, appraisals and whistleblowing. We are confident that by making corporate culture one of the CEO's primary goals, Naver will not face similar issues in the future.

Changes to the portfolio

During the period in review we divested our holdings in Astra International and Bank Rakyat, both in Indonesia.

Astra International, which we have owned in the strategy for more than three years, is one of Indonesia's top-quality franchises. It is a conglomerate and part of the Jardine Group, with five main businesses: Auto Manufacturing and Distribution (40% of sales), Heavy Equipment and Mining (34%), Financial Services (11%), Agribusiness (11%) and Infrastructure (4%). Driven by the highly profitable auto and auto-financing businesses, Astra has an attractive return on equity (ROE) profile (averaging around 30% from 2005-15), which in recent years has been depressed owing to poor macroeconomic factors and the increased allocation of capital towards lower ROIC segments (infrastructure projects, such as toll roads and ports). In several meetings, we highlighted our concerns with this capital allocation approach. In addition, we were increasingly worried about Astra's carbon footprint, which was becoming untenable on account of its contract coal mining operations. We discussed the topic with Astra's management as well as the managers at parent entities Jardine Cycle & Carriage and Jardine Matheson (of which our clients are also shareholders via FSSA's Asia strategies). However, as manager incentives are not being tied to ROIC or ESG-related metrics, it is difficult to see the likelihood of sustainable changes being made.

[2] CXOs are the Chief Officers in an organisation, with "X" to denote the different business areas or departments.

[3] Adjusted earnings before interest, tax, depreciation and amortisation

[4] non-Generally Accepted Accounting Principles

Our investment case for Astra remains unchanged; in essence we believe that the prolonged slowdown in auto sales will reverse, thereby improving returns to previously high levels and resulting in a significant re-rating of the valuations. Notwithstanding this belief, we have decided to divest our shares on concerns that the longer-term direction of travel will not be so positive after the inevitable recovery.

The other divestment we have made is Bank Rakyat (BRI), Indonesia's largest bank focused on micro-lending. Despite being an SOE bank, BRI's long-term track record since listing in 2003 is good. Asset quality has remained in check (10-year average non-performing loans (NPLs) is at 1.3%) and book value has compounded at an impressive rate of 15% in USD terms despite the Global Financial Crisis (GFC) and more recently the Covid-19 pandemic. This is largely due to its superior micro-lending franchise which over the years has proven to be exceptionally profitable and highly defensive. In addition, KPIs for the senior management team have always been sensible and much closer to the best among private peers, combining good corporate governance policies and transparent practices with sensible financial targets focused on net profit and assets (in other words, return on assets), NPLs and capitalisation ratios.

However, we have become increasingly concerned about our alignment as minority shareholders and the risk of BRI being forced to do 'national service'. Historically we have viewed this risk as being limited, given that the Indonesian banking system's implosion during the Asian Financial Crisis was precisely because many of the leading state banks were forced to support the economy. Since then the Indonesian regulator and various governments have prioritised a healthy, profitable financial system over stimulus and financial inclusion. But we are starting to see early signs of the government's changing stance. In June 2021 BRI was 'forced' to absorb two other Indonesian state-owned banks focused on micro-lending, in a deal that might have been small (the balance sheet of the two lenders are less than 7% of BRI's), but was financed in a less-than-ideal way through an unusually-large rights issue. This suggests there may be more forced M&A down the road.

The deteriorating alignment combined with the fact that the share price had recovered to pre-Covid levels gave us an opportunity to reposition our clients' capital to more attractive ideas. We decided to sell out of BRI.

One of the new investments that we made following these two divestments was CAMS in India, which we discussed in our previous update. The other new investment is Anta Sports in China, a domestic market leader in Chinese sportswear. The company operates well-known and popular sportswear brands like Anta, FILA and Descente in China, as well as leading sports brands including Wilson, Salomon and Arc'teryx on a global basis.

As a team, we have followed Anta since its initial public offering (IPO) in 2007. Over the past 15 years, the company has emerged from being a mass-market shoe brand to China's most successful multi-brand sportswear company. During a period of cyclical share price weakness, we conducted research on the company and came away impressed by the founding Ding family's strong ownership, the chairman's vision, and the management team's solid execution.

We believe that this combination of long-term owners (the Ding family still holds circa 55% of shares) and well-incentivised managers has been vital to Anta's success. Among the professional managers brought in by the company are former Reebok China CEO James Zheng and former Lacoste China CEO Brian Yiu, while John Yang from FILA Korea has been entrusted with its Descente and Kolon brands. These high-calibre managers were granted long-dated share options (10 years) and restricted shares (vesting over five years), thus strongly aligning their interests with Anta's long-term success. It is a testament of the management's belief in Anta that a large part of the options awarded back in 2010 was only exercised in 2020.

Looking ahead, we believe that China's sportswear sector will continue to grow strongly, with Anta taking further market share from global peers. For a long time, Nike and Adidas have dominated the high-end sportswear segment, but Chinese consumer preferences are changing in favour of domestic brands that have steadily improved in product quality and brand power. In 2020, Anta's brands had a combined market share of around 15% (retail value), right behind market leaders Adidas (17%) and Nike (20%). According to our estimates, Anta should have overtaken Adidas and claimed the No. 2 position in 2021. With its premiumised product offering, a recovery from the pandemic and solid long-term prospects at acquiree company Amer Sports, we believe that Anta can further improve its already attractive ROIC (currently at an average of 24%) and its cash flow generation (average 110% operating cash flow/net income) in the coming years.

While all of these factors point in a positive direction, Anta Sports is by no means a perfect company. When conducting our research prior to investing we uncovered several areas which have room for improvement, including supply chain management, diversity and remuneration. We started engaging on these points and wrote a letter to the chairman to explain our position. Reassuringly, we believe that Anta is aware of the issues and will be proactive in making changes. In December last year the company announced comprehensive sustainability, diversity and social targets at its 30-year anniversary, which will be implemented as part of senior management KPIs.

Given the strong franchise, and the impressive management team coupled with a founding family that we believe genuinely wants to be at the forefront of sustainability-related matters, we have bought a small position for our portfolios and will continue to engage on these matters. These efforts should hopefully lead to greater conviction and a larger position in the portfolio in due course. At the time of purchase, Anta Sports was trading at a free cash flow yield of 3.5% which we view as attractive.

Outlook

The start of the year has been volatile with several popular "growth stocks" being brought rapidly back down to earth. Fortunately, our holdings have been weathering the storm well and as we noted in our previous letter, we continue to be optimistic about their prospects, given their successful navigation of the peculiar challenges posed over the past two years. As economies open up, several of our holdings which are exposed to travel and dining will enjoy powerful tailwinds, having pruned both their costs and balance sheets. They are structural compounders by nature, with strong competitive advantages, defensive balance sheets, attractive growth opportunities and solid management teams, which should ensure solid returns in years to come.

At the time of writing this letter, the situation in Ukraine has deteriorated following Russia's unjustified invasion of the country. While it is still too early to say what the longer-term ramifications will be, the obvious first-order consequences are tougher sanctions on Russian companies. On that note, we should point out that we have not owned any Russian companies in the strategy for several years. As an investor focused on quality companies with strong business models, robust balance sheets and proven management teams, it is hard to find many of these in Russia. Challenges with the ever-intervening state, opaque company structures, stretched balance sheets and a lack of transparency on managerial decisions are factors which have kept us on the sidelines.

Still, the second-order implications could result in a further strain on global supply chains, particularly those that rely on natural resources and soft commodities exported by Russia and Ukraine. We are monitoring the situation carefully. By and large, we feel confident in our holdings' ability to navigate the situation, as they have done in the past. Competitive advantages in the form of strong brands, distribution advantages, cost leadership or simply providing a service/product that customers cannot live without, are the main traits that characterise our companies. Historically, this has given them pricing power and the ability to preserve margins despite adverse headwinds. While past performance is certainly no guarantee for the future, 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 which 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. Financial metrics and valuations are from FactSet and Bloomberg. As at 28 Feb 2022 or otherwise noted.