ARISAIG QUARTERLY JANUARY 2019

Wednesday, 09 January 2019

As mentioned in our Diary last month, this is the first edition of our new format of quarterly investor letters covering all Arisaig Funds. We believe these notes will be more reflective of our process and of our long-term outlook; and hope they will allow us to provide more useful and in-depth reflections to our partners.

At the same time, we recognise that many readers valued the regular detail previously provided on performance attribution for each fund. Our revised monthly Diaries are intended to meet, and hopefully exceed, this requirement. This is merely a first iteration of these new bulletins – as ever, we welcome feedback as to how we can improve our disclosures and communications.

We wish all our investors a happy and prosperous 2019.

2018 Performance

This was a typically volatile year and, sadly, not a rewarding one for emerging market investors. A survey of calendar year performance of our relevant stock market indices and currencies shows a sea of red. Though there were, as always, some stock selection decisions which we got wrong, the headwinds of negative sentiment towards EMs (primarily manifested via currency depreciation, with a smaller dose of de-rating) were particularly tough to overcome this year.

The Asia Fund, which ended the year down 4.5%, was our safest haven. In fact, in the context of a plus 52.7% performance in 2017, this modest decline in 2018 is a relatively satisfactory result. Our inadvertent, bottom-up-driven 'overweight' to India, as compared to the more East Asia-heavy index, explains much of our 'outperformance' against the overall Asian market. Returns were quite stable until September, at which point the mid-year bout of broader EM panic seemed to make a belated arrival in India, amid fears of a local shadow banking crisis and (temporarily) higher oil prices.

As these fears abated, we did watch with some trepidation as Prime Minister Modi's BJP lost a string of state elections (potentially a negative read on their re-election prospects in a few months' time) and the RBI governor resigned, calling into question the independence of India's Central Bank. The market's seeming indifference to these most recent stories suggests that their eyes are fixed on the coming quarters of pre-election handouts, rather than on the longer-term integrity of Modi's reform programme. We would have preferred to take a hit to short-term performance and to have seen no divergence from the path of genuine structural reform in India. But we do take some comfort from the fact that our portfolio of high-quality Indian consumer names has delivered for us even throughout previous Congress administrations. In other words, the power of our holdings to compound earnings growth, year after year, endures even without the help of political or macroeconomic tailwinds.

For our Global Fund, a similar if slightly smaller 'overweight' to India (around 30% of NAV) was a positive contributor this year. So too, for the most part, were most of our China-facing names (Foshan Haitian, Vitasoy and Orion Corp). These were offset by our exposure to some of the EM 'problem children' of 2018 – Turkey (where the market was down 41.4% in USD terms), Mexico and (indirectly) Argentina. The Fund ended the year down 11.1% (BVI) and 7.6% (the Euro-denominated UCITS vehicle). Although it is always disappointing to notch up negative returns in any given year, our relative performance was at least meaningfully ahead of any of the global EM indices (general, consumer staples and consumer discretionary). This means that in the five years since launch, the Fund has

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attained returns a fair bit ahead of these two consumer-related indices, albeit still marginally behind the broader EM index.

In 2018 we decided to exit the investments this Fund held in the Western-listed consumer multinationals. The objective here is to re-focus allocation on smaller 'local champion' type businesses indigenous to emerging markets. We believe that such companies have far more optionality for revenue growth (turning USD1bn into USD5bn is more feasible than turning USD50bn into USD250bn) and better alignment with the objectives of long-term minded investors such as ourselves (reinvesting for growth and utility to the consumer). These changes are also intended to make our portfolio more representative of consumer habits, which have changed significantly since the launch of the Fund (we write in more detail on our approach to digital consumption platforms below). We believe 2018's 'portfolio reboot' has considerably enhanced the long-term returns potential of the Fund; as well as distilling our value-add, as purely EM-focused investors, to our client base. Portfolio turnover in 2018 was unusually high as a result of these changes, but our intention is to return to our model of minimal trading activity in 2019 and beyond.

Turkey was also the main detractor in another painful year for our Africa & Middle East Fund (down 17.0%). This is particularly frustrating since many of our African holdings were only just beginning to recover from a period of savage currency devaluations. At some point the tide of negative news will turn. But we cannot just sit still and hope. We undertook a comprehensive review this year of our failure to generate results in Africa (available as a white paper to those who are interested). Among our mistakes was an overreliance on multinational subsidiaries (discussed more below), as well as a tendency to put too many eggs into individual currency baskets, foolhardy in a region prone to extreme volatility. We believe the Fund is now on a much firmer footing. For those investors with a long enough time horizon to care about demographics, frankly there is no more compelling consumer story on the planet than Africa. And for what it's worth, amongst Arisaig insiders looking to put some of their savings to work, Africa has been comfortably the most popular Fund choice over the last 12-24 months.

We were telling investors in Latam at the start of the year that politics (namely elections in Mexico and Brazil) would be particularly significant drivers of performance in 2018, a handy way for us to predict volatility but sit on the fence in terms of its direction. Our Fund was down 11.2% over the course of the year. In the end we were grateful for our material exposure to election-free Peru in the shape of InRetail (pharmacies) and Backus (beer). The market diagnosis of regime changes in the continent's two major economies, was Mexico bad, Brazil good. But once currencies were taken into account (dragged down by broader negative EM sentiment) both these markets ended the year in the red, albeit with Brazil (minus 1.8%) much more tempered than Mexico (minus 13.7%). Argentina outdid them both, collapsing by 50.2% in Dollar terms, amid a fiscal deterioration and an IMF bailout. Unlike Turkey, Argentina's current economic management is in fact quite 'by the book' – the objection of the markets seems to be that in cleaning up the mess of the Kirchner years, President Macri initially proceeded at quite a measured pace, in an understandable attempt to soften the social impact of austerity.

Still, it is worth reiterating that we own no direct investments in Argentina, only two US-listed, Argentina-based consumer digital names which benefit from the relatively strong supply of tech talent in Buenos Aires but whose ambitions are very much pan-Latam. As a result, for both MercadoLibre and Despegar.com, performance in Brazil is generally much more meaningful, though inevitably the sharp fall in the Argentinian Peso (50.6%) brought about a considerable negative translation effect for

reported Dollar revenues of their domestic operations (c.30% of total). Additionally, online travel agent Despegar has suffered somewhat of a ‘double whammy’, since with flights and foreign hotels priced in Dollars, Latam consumers have also seen their purchasing power of travel products temporarily crimped by the sharp correction in some of their local currencies.

The Year in Fundamentals

We share this performance commentary in the hope that it provides helpful context for assessing our returns in 2018. But, as ever, we attempted throughout the year to ignore the ‘macro’ drivers of sentiment, which we cannot control, and focus on the ‘micro’ – namely whether or not our chosen portfolio continues to generate cash. We think, despite the up and down markets (more down than up), 2018 was actually quite a promising year on this front.

In recent years our India names have had to deal with major twin disruptions in the form of, first, demonetisation, and second, the introduction of a Goods and Services Tax (GST). The latter in particular we viewed as a long-term positive, easing the bureaucratic burden on truly nationwide, formal, tax-paying businesses, squeezing out informal competitors, and hopefully contributing to a firmer tax base with which to eventually fund much-needed infrastructure improvements. Nonetheless, the adaptation period was undoubtedly tricky, helping to ‘artificially’ suppress volume growth in India for a second consecutive year into 2017.

It was a great relief, then, to see our Indian holdings return to double-digit volume growth in 2018, suggesting that underlying demand remains robust, and that the disruption of the last two years was temporary. It was all the more encouraging to witness our companies begin to ‘lap’ double-digit growth quarters and successfully maintain their speed, providing encouragement that the return to growth is not merely attributable to the re-creation of a low base.

In the second half of the year, we did begin to see some evidence of a broader consumer slowdown in China. In terms of revenue growth at least, we have managed to avoid too much impact, largely by being on the right side of premiumisation and market consolidation trends (for instance the dominant condiments player Foshan Haitian). In ASEAN, Pakistan and Bangladesh, industry-wide demand growth did not hold up as well as in India, but for the most part, category and geographical expansion has kept our holdings’ top lines looking healthy. We forecast the overall Asia portfolio to have delivered a weighted average of 15% sales growth and 11% EPS growth in 2018.

As mentioned, in Africa we have for the most part seen a strong recovery from our companies to the bleak, currency-driven downturn in revenues and margins over the last few years. Turkey provided an unwelcome interruption to this process, but overall our portfolio is expected to have delivered 10% sales and 13% earnings growth during 2018. Our Latam businesses, meanwhile, appear to have sailed quite serenely through all the political upheaval, albeit with plenty of ‘noise’ from currency translation effects for those unfortunate enough to report in Dollars. Portfolio sales growth ticked along at a low double-digit rate, as it has done for several years. Given below-the-line (non-operating) adjustments at a few of our holdings, we forecast Latam portfolio earnings to have edged up just 2% in 2018 but are projecting a bounce back to plus 26% for FY19. We are loath to do too much ‘adjusting’ to these figures but note that EBITDA growth in both years aligns with sales, so one could ‘average out’ FY18 and FY19 earnings growth at a similar rate (low double digits).

The Global portfolio, predictably, encompasses a mix of all the above. Its few non-overlapping names, such as Russia's Yandex, had a strong year in operating terms; but the Fund does share exposure to some of the EPS 'laggards' in Africa and Latam. The Fund overall, therefore, achieved a weighted average 11% sales and 6% EPS growth in FY18. We expect top line growth to continue at a similar rate over the next twelve months, with earnings growth returning to low double-digit levels.

Digitalisation and our Strategy

Both MercadoLibre and Despegar are prime examples of businesses which we believe will benefit enormously from the inevitable 'channel shift' away from bricks-and-mortar retail towards digital, particularly mobile, forms of shopping. This journey is still at an incredibly early stage in Latin America. But even in the most digitally advanced markets such as China, there is still a long way to go.

Hence our investment at the tail end of 2017 in JD.com, through which we specifically targeted the channel shift in grocery and FMCG retail – the last big prize in Chinese e-commerce, in which we expect delivery speed, service quality and guarantees of product authenticity to be important determinants of success. This still holds true, though of course our investment here is off to a very bad start. The main worry we have around our original thesis is that Alibaba's rapid progress in omnichannel retail (e.g. Hema supermarkets) is, while far from being an economically proven concept, helping to close the 'trust gap' between its own formats and the brand of JD.

But this does not explain JD's poor performance this year – instead the blame lies squarely on the shoulders of Founder and CEO Richard Liu, whose indiscretions in America readers will be familiar with. Unfortunately, all CEOs, at both digital and analogue businesses, are capable of committing catastrophic behavioural errors. If there is a lesson we can draw here for future investments in digital consumer names, it is perhaps that key man risk can be particularly heightened in this space, due to the recency of each company's foundation and their tendency towards imbalanced voting rights. Richard Liu's self-inflicted absence did, at least, force JD to restructure its management and bring to light its 'bench' of executives. And thankfully, MercadoLibre and Despegar have for some time both had much cleaner, more conventional corporate structures. So too does Yandex, the Russian digital platform we own in the Global Fund, though its affiliation with state-owned Sberbank does seem to create occasional market noise.

More broadly, it has become even more clear to us this year that we have to consider the effects of digitalisation on all of our businesses. This is not a theme which we address solely through our investment in tech platforms, which even now remains very limited (c. 5% of Arisaig-wide NAV). Far more important to us will be how the remaining 95% of our consumer companies will fare in the digital age. Indeed, to paraphrase outgoing Unilever CEO Paul Polman's message at their investor day in Mumbai in December, the next generation of winners among conventional CPG companies will be those that view digitalisation as an opportunity to be seized rather than as a threat to be managed.

What does this mean? Illustrative examples include Hindustan Unilever and Marico, which have both built data analytics into their business models to an impressive degree and are using these capabilities to become nimbler, more reactive and more efficient. Or Vitasoy, our Chinese soy milk business, which has exploited the rise of e-commerce to find a much broader mainland audience than the Southern Chinese base it used to be confined to by its distribution capabilities in the bricks-and-mortar channel. Another example might be Domino's Pizza, of which we now own two master franchisees (in India and Turkey) – a business which has always excelled at home delivery, but which has successfully tied this

to best-in-class ordering technology to become a key beneficiary of the increasing tendency for consumers to summon dinner from their smartphones.

As digitalisation brings about subtle changes to spending patterns, we believe it is our duty to continue seeking the best possible ways to capture the rise in emerging market consumption, and to 'follow the consumer' wherever she goes, rather than remaining rigidly wedded to the 'Eat Drink Wear Wash Shop' categories we favoured in the past. The emergence of entirely new business models brings with it greater potential for us to err in our analysis of the sustainability of competitive advantage at these relatively unproven companies. But this potential downside comes with (we think much larger) potential upside. The gradual appearance of newly listed digital platforms is expanding the universe of high-growth consumer businesses available to us, allowing us to be even more discerning in selecting those which most completely fulfil our other requirements: namely strong corporate cultures, wide competitive moats, a focus on sustainability, and resilience to macroeconomic turbulence.

Taking a further step back, we do see some substance to the idea that digitalisation is a significant positive for the development of the countries we invest in, acting as an accelerating force to the formalisation of industries and of financial inclusion. It could also prove a hindrance to tax avoidance and corruption, which have for a long time been a brake on emerging market growth. Digitalisation is most certainly enabling entire industries to 'leapfrog' centuries-old physical barriers to expansion. To use but one example, it is evident that the digital payments industry is (in different forms across different markets) near-instantly addressing a chronic lack of traditional banking access across each of our target regions.

Multinational Subsidiaries

2018 saw us bid goodbye to two MNC subsidiary stalwarts in our Global portfolio – Colgate India and Unilever Indonesia (our Asia Fund retains a small stake in the latter). Both have proven more-than-sound investments for us historically. But the forward-looking picture is less rosy, as both struggle to react to the incursion of smaller 'local champion' competitors into their core categories. At the same time, both continue to command among the most challenging of valuations in our investment universe, a result of a perception of reliability which arguably has outlived the reality of recent operating performance. Valuations are also buoyed by the hypothetical possibility of the parent increasing their stake at some point in the future, an insufficient basis for our ongoing investment. We are not abandoning these names in disgust, we simply believe that we can find better places for our investors' capital – often by reallocating to one of the growing number of improving 'local champions', which are often family-run (and therefore long-term minded) but fast professionalising; and which tend to be more agile and focused than their foreign competitors.

But this is, of course, not a blanket policy on our part. In fact, we have come to view a select few multinational subsidiaries as encompassing the best of both worlds – enjoying continued access to the brands, R&D and digital innovation platforms of the parent, while boasting the agility and domestic focus of a local champion. This only takes place when the subsidiary is empowered to become a truly local business. Nestlé (in the years following the Maggi incident) and Unilever in India are two such examples, with almost fully homegrown management teams and a steady stream of innovations tailored to the Indian consumer. Both are much more authentically Indian than Colgate, whose recent response to evolving consumer tastes within the oral care category was alarmingly sluggish; and where

senior management is still imported. For these foreign executives, leadership in India is often viewed as a temporary stepping stone rather than a career pinnacle.

We find it helps if the subsidiary is of sufficient scale to wield influence at the parent level. In Africa, for example, the Nigerian subsidiaries of Nestlé and Heineken are viewed as core strategic assets and are thus afforded adequate investment to support their long-term growth prospects. In contrast, it became evident to us that the Diageo subsidiaries in Africa (all of which we have now exited) were being run solely on the basis of maximum short-term profit extraction to London. Somewhat counter-intuitively, we remain happy investors in AB-InBev's subsidiaries in Peru (Backus) and Tanzania Breweries which we revisited this month.

Though 3G's endless cost-cutting may have caught up with them in saturated beer markets such as the US, we are satisfied that they see the importance of volume growth in their more underpenetrated territories – in fact, they see it as fundamental to offsetting ongoing declines in the developed world. The ruthless efficiency of the 3G culture may actually help maintain affordability of the product in African markets, thus providing a greater incentive for consumers of 'informal' alcohol to transition to branded beer. We know from the astonishing performance of ABI's Brazilian subsidiary Ambev from the late 90s to early 2010s that, as a consolidating force in markets with a tailwind of consumption per capita growth, the Brazilians can create a huge amount of value over a much longer time period than they have seemed capable of during their more recent zero-growth, margin-fattening efforts across the American food and beverage sector.

Firm Update

As most investors will know, Arisaig continues to implement a succession plan whereby equity is being ceded to a new generation of partners. The founders, James, Lindsay and Torquil, have drawn much satisfaction from the way that Rebecca, Chee Seng and Hugo, our first three successor partners, have been managing Arisaig for the past four years.

We are delighted to announce that we have now appointed two new partners, Gordon Yeo and David Lanning to join them. In recent years, the firm has been run by a Management Committee comprising the first three successor partners. In recognition of the accession of Gordon and David to the partnership, this committee has now been dissolved, with Rebecca assuming the fuller responsibilities of a Managing Partner and able to draw on the expertise of this enlarged group of five.

The promotions in January will lead to five successors sharing 20% of the equity of the business, and the founders are very much looking forward to working with this expanded group of partners. Looking to the future, the founders have indicated their intention to retire from the boards of the Funds at the end of 2020. Beyond this date, they are expected to sit on the board of our holding company as directors and from this vantage point exercise oversight of the investment process and strategy for the firm, as well as continuing to provide mentorship to the partners.

We are also pleased to announce that Alice Townshend will be taking charge of Latam with immediate effect. Mindful of the benefits of consolidating the Arisaig office footprint and encouraging more face-to-face debate and cross-regional expertise within our analyst groups, we have now decided to move our entire Latam research team back to London alongside her. Faithful to our business model of being extremely close to portfolio companies and opportunities, there will be no diminution in the intensity of our visiting programmes to ensure we uphold the 'boots-on-the-ground' principles we still find invaluable. João Rosário, our former Head of Research in Latin America, is moving on to pastures new.

We thank him for his commitment and dedication over many years with Arisaig and wish him every success in the next chapter of his career.

Many of you will have already heard from Lucy Carmody, our Head of Business Development, regarding the opportunity for you to attend investor trips to several of our markets during 2019. Please do let her know as soon as you can if any of these trips should be of interest. We hope to see as many investors as possible on our emerging market home turf over the course of this year.

Arisaig Partners

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