Tuesday, 07 April 2020

From the archives:

> *…the most important lesson of all that we have learned (not for the first time) is the importance of not trying too hard. Those investors that just sit on the best businesses and eschew chasing fads or short-term trends always come out on top in the long run…. our cashed-up, market-leading consumer stocks will weather the storm and emerge stronger for it. We cannot predict tomorrow. All we can say is that there will be a brighter tomorrow and that we will be around to enjoy it.*

Arisaig Diary – December 2008

Staying the Course

When Arisaig first started investing back in 1996, we were in short order given our baptism of fire through the Asian Financial Crisis the following year. Since then, we have lived through 9/11, the dotcom bust, SARS, the Global Financial Crisis and everything in between.

An important lesson we have learned through these experiences is that we must recognise the limits of our own knowledge. This is perhaps the hardest behavioural discipline for investors to grasp, and we are by no means the finished article in this regard.

There is so much we do not know about the COVID 19 virus: how it spreads, how long it will last, whether adverse second order economic effects may emerge in credit markets and so forth.

Yet counterintuitively, embracing ambiguity lends a certain clarity. By shutting out the noise, accepting what we don't know, we can focus instead on what is knowable or at least what is most probable. With that in mind, there are a few assertions we can make with a modest degree of confidence.

First, although things may seem grim in the midst of any crisis, the sun does rise again. The epidemic will end, everyday life will return. With the right policies in place, and with sound management of healthcare resources, we know that this virus can be dealt with. In time, a more permanent solution will be developed.

Second, good businesses with strong balance sheets, healthy cash flows, and fundamentally robust business models will survive, and in many cases emerge stronger than before.

Third, if you own those businesses, hold them, and resist the urge to do anything too clever. The quote at the top of this letter, from the depths of the Global Financial Crisis, pretty well sums up our approach today.

Our plan is simple: hold our nerve, stay within our circle of competence, stick with quality, and trust in the management of our holdings to see us through to the other side of the crisis.

Turning to the day-to-day practicalities of managing our own business, we've been on a work-from-home policy for much of the past two months. Fortunately, we moved to flexible working some years ago, meaning we were already comfortable with remote working both from a cultural and practical standpoint. Our migration to cloud-based systems last year also proved timely.

The biggest change for us has probably been the complete halt to our travel, normally such an important part of our routines, especially for the investment team. Yet the past few months have introduced us and our holdings to new ways of working, meaning that the frequency of interactions has not changed a great deal – it just takes place over videoconference rather than in-person. Ultimately, this experience will support our climate change mitigation actions as we move from our historical approach of offsetting to setting carbon targets.

A clear benefit of this regime is that it provides an opportunity to settle into a routine of quiet research and contemplation. We have always aspired to create a thoughtful, reflective culture and our hope is that the current situation helps to embed that further. Instead of dashing to the airport or battling Mumbai traffic, we can slow things down and spend our time reading, writing, thinking; literally cutting out the noise. We've taken advantage of the enforced time at our desks (or kitchen tables) to pore over our current holdings, together with a few names on our pre-existing watchlists.

As ever, our job is to curate a very high-quality portfolio for the long term. We certainly won't be bottom-fishing in lower quality names just because the stock price has tanked. As we have learned from hard experience over the past two decades, the economics of so-so, less resilient business models have a habit of unravelling very quickly during times of macro stress. Something that has fallen 50% can very well fall by another 50%.

Hence the general rule is 'steady as she goes'. As we describe in the following section on the fundamentals of our holdings, we are generally content with the structure of our portfolios, and hence do not see the need to change too much. We are managing our target holdings and weightings as we would for a portfolio under fair weather conditions: strategic as opposed to tactical positioning.

That said, for long term investors like us, volatility can create a window of opportunity to hone the portfolio, allowing us to bring in in some exceptional businesses that are now trading at a reasonable price. In a small number of cases, the intrinsic value of the company in question may actually be higher as a result of this crisis, sometimes not reflected in share prices that have been hammered by an array of negative feedback loops, be it passive flows, margin calls, algorithmic trading, or other nonsense.

As usual, we are not compromising on due diligence. These new additions are stocks we had already been working on for a long time (sometimes years), and where we have been waiting patiently for the right entry point.

We have no idea whether share prices in these names will continue to decline, or by how much. This is yet another thing that is unknowable. Hence we have been chipping away at these buy orders gradually – usually through small pre-defined daily amounts – as opposed to trying to time the market with strident 'calls'. We don't know, but if we had to hazard a guess, we suspect that volatility will continue for a while yet, so it seems sensible to not be too cute on timing. This patient approach to the way in which we buy at least partially insulates us from the considerable noise and emotion that is fuelling the ongoing spasms in the market.

The Partners and others within the firm have made top-up subscriptions to our funds over the course of the first Quarter. There may be difficult times ahead, but we will be sharing the ups and downs with our investors, whose support has remained solid. We often say that the biggest competitive advantage that Arisaig has is the quality of its investor base. This matters especially during times like this, allowing us to hold firm to our strategy whilst others become forced sellers.

We are incredibly proud of our team and how they have risen to the challenge in quite extraordinary circumstances. We are confident we will emerge stronger when this is all over. Yet amidst all of this, we must remain cognisant that we, and others in our industry, went into this crisis in a fortunate position. Many do not have the luxury of being able to work from home with minimal disruption, or to look out beyond the next few months. When we think we are under pressure because a stock price falls, we must remember this is not real pressure (healthcare workers on the front line will tell you what that is). We hope that the crisis gives our firm, our industry and wider society some perspective on what is actually important, what is real. Looking after our families and local communities. Taking time to breathe, slow down and think. Learning respect for the natural world.

Fundamentals of the Portfolios

The performance of our stocks has generally been slightly better than wider markets, yet on certain days when selling frenzy really grips, even higher quality names are punished indiscriminately along with the rest. Much of this is irrational, driven by some arcane combination of machine trading protocols and human panic.

Whilst this is hard to watch, a better use of our energies is to focus on the real fundamentals of the businesses in our portfolios. We describe below some of the shorter-term challenges faced by our holdings, but what interests us most are the long-term structural changes that may occur. Looking at the latter in very broad terms, there are two major changes that we foresee:

1) Accelerated industry formalisation and consolidation: businesses with strong balance sheets and strong cashflows will survive, smaller informal rivals may not

2) Changes in consumer habits, expansion in the installed base of users. This is particularly relevant to app-based businesses

Branded staples – broadly resilient, but caveats apply

The core of our strategy is branded consumer packaged goods. The impact of COVID 19 on operations here has probably been somewhere between neutral to slightly negative. These types of businesses are generally fairly secure on the demand side because of the nature of what they sell – everyday, low unit price items. Most of our holdings focus on 'in-home' consumption, although we do have some exposure to on-the-go or out-of-home consumption which will be more affected (e.g. our breweries).

On the supply side, there has not been wholesale disruption so far, mainly because staples businesses are typically not reliant on highly complex or long supply chains. Making packaged soy milk or soy sauce, for instance, requires less than a dozen main raw materials, mostly agricultural commodities. Contrast that with, for example, an electronics hardware manufacturer, which needs hundreds of complex components (each of which has its own long supply chain requirements), and simply cannot

operate if just one such component is not available. One reason we have had a bias towards branded consumer goods companies for the past two decades is because they are relatively simple.

As usual, caveats apply, and the scene is by no means rosy. It would be delusional to imagine there will be zero impact on staples companies' supply chains. Factories involve concentrated groups of people, and hence are vulnerable to temporary shutdowns – some have already been shut down by zealous local authorities in India. Hypera Pharma is reliant on imported Active Pharma Ingredients (APIs), meaning we suspect it may have trouble actually fulfilling the likely strong demand for its products in Brazil. In the case of Asian Paints, a more discretionary category with a very different distribution set-up to the branded staples players, we have seen disruption already in the route to market, meaning the company has voluntarily suspended all production.

Store-based businesses – short-term pain, but long-term growth drivers likely enhanced

The second big category of businesses in our portfolios are those which depend on foot traffic – mainly retailers and food-service chains, but also our Brazilian payments company Stone which services these types of outlets. The impact here is quite varied. Our drugstore operators (Clicks and Raia Drogasil) should hold up given the nature of what they sell. At the other end of the spectrum, our foodservice holdings are going through a very tough stretch, with people naturally wary of crowded environments and preferring to eat at home. HaiDiLao (HDL) closed its restaurants for most of Q1, but continued to pay all its staff their normal salary (in line with its values as an organisation). This led to considerable cash burn, and will mean that store openings (a major growth driver for HDL) will also be much lower this year. Short term results are likely to be pretty ugly, hence the big downgrade we have applied to our EPS estimates on this company. That being said, HDL's control of social media so far has been excellent, the clear messaging being that the company is going above and beyond when it comes to hygiene, something that the main competitors to HDL – small, independent restaurants – will find far harder to communicate in a credible manner. If this crisis does accelerate the pace of HDL's market share gains in this highly fragmented industry, this may be a case of intrinsic value actually increasing.

More discretionary retailers such as Lojas Renner, Trent and Future Retail are also likely to face a tough stretch in the coming months, with almost all of these stores being closed. As described above with HDL, the investment thesis for these names is based on the twin drivers of industry consolidation and formalisation, which will likely be accelerated by the epidemic.

Digital consumption – likely beneficiary

Turning to our other digital consumer names, the picture is varied but generally more positive. The real star has been JD.com, a sizeable holding for both the Asia and Global Funds. The company was already displaying excellent operating momentum (Q4 results were very strong) and indicated that even during the height of the Chinese lockdown it grew its core ecommerce business at double digits, taking share from its main rival Alibaba (which declined). Our core thesis for investing in JD.com was its self-owned, fully integrated logistics capabilities. The advantage of this versus Alibaba's outsourced system is that it allows full control over inventory, higher quality delivery, better network reliability, and faster speed. Admittedly, we did not expect these capabilities to be stress-tested in such an extreme scenario as this, but this crisis has shown what a valuable asset JD's logistics are.

The company also cited strong performance for its grocery / FMCG categories – this is the last really big chunk of consumption that is yet to move online in China, meaning that if this crisis changes habits

towards ordering these categories online, and if consumers decide that JD is the most reliable way to make those orders, this could be very positive for the company over the long term.

Jubilant Foodworks (aka Dominos India) will be hurt on the dine-in side, but otherwise should be quite well-placed given its focus on mobile e-commerce and delivery (60% of sales). Unlike informal restaurants and the online food aggregators that serve these, Dominos has a trusted brand and full control over its own delivery function (like JD), meaning more reliable fulfilment and a better chance of controlling hygiene. Of course, this mitigates but does not negate the risk of an outbreak of the disease in a store or a production facility.

As for MercadoLibre (MELI) and Yandex, their USD-denominated stock prices have been hammered on account of the oil price collapse brought on by the implosion of OPEC (March's other 'Black Swan' event!) and resultant currency devaluation in Latam. There may be some short-term disruptions for both companies associated with interrupted supply chains for smartphones and electronics, and MELI's payment arm may be temporarily hurt by offline store closures.

One obvious short-term casualty within our digital exposure is Despegar, the online travel agent held in the Global Fund and Latam Funds. Travel is obviously a more discretionary area of spending and demand does ebb and flow, but a complete sudden stop is unprecedented. What does this mean for the company long term? We may see acceleration in both industry consolidation (Despegar should prove more resilient than other regional players) and the offline to online shift (the latter is a far more efficient marketing tool from the perspective of travel suppliers). On the other hand, the pandemic might mean a structural decline in demand for travel, and possibly destruction of large swathes of the supplier base (hotels and airlines).

Despite these caveats, the general rule is that app-based businesses should be long-term beneficiaries of this crisis. With much of the offline and store-based economy shut, many new users are downloading apps and trying online services for the first time.

In a strange circularity of history, it was the experience of SARS in 2003 that hastened the development of what was then a nascent ecommerce sector in China. This was the point where JD was forced out of sheer necessity to pivot from an offline electronics retailer to a purely online retailer. Given that it is far more serious and widespread than SARS, we believe that the coronavirus may have an even more profound impact in accelerating ecommerce and digital services penetration across emerging markets. Perhaps more important is the fact that online infrastructure is incomparably more sophisticated than in 2003, in particular the fact that the app-based mobile internet is accessible to billions of EM consumers.

We are seeing early data come through suggesting an acceleration in both app downloads and usage for our holdings in this space. This is important because once a given customer has downloaded the app in question and (hopefully) had a good experience with the service it offers, that person is more likely to become a repeat, loyal customer, possibly for years to come.

New Holding: SEA Ltd

With the above point in mind, this is a good time to introduce the latest addition to our Asia and Global Funds: SEA Ltd, a digital platform operating across gaming, ecommerce and payments in South East Asia.

The basic model here is quite simple: use the highly cash generative online gaming side of the business to fund growth in ecommerce.

The SEA gaming division, known as Garena, is the dominant online gaming publisher and developer in ASEAN. Although the publishing side is a very decent model, the real jewel in the crown here is a self-developed mobile game called “Free Fire”, a ‘battle royale’ format in a similar vein to Fortnite but adapted to emerging market conditions. It can run at lower latencies on 2G smartphones and offers a 30-50-person game lasting for 15-20 minutes as opposed to Fortnite’s 100-person game for 30-40 mins. A game format like Free Fire requires a critical mass of users to be online and active at any given point in time in order to matchmake players and arrange a game quickly. This is basically a same-side network effect (similar to what one sees in social media networks), and one which we think is relatively hard to replicate on account of this need for high user ‘liquidity’. The mobile aspect to Freefire, and the fact that each game is short, encourages very high levels of user engagement and retention, both of which lead to healthy monetisation and stickiness.

The game has been so successful that today it has about 450 million registered users versus 250 million for Fortnite. It was the most downloaded mobile game globally in 2019. It is a huge franchise in its home market of ASEAN, but also in Brazil (where it had no presence in the past). It is now starting to gain traction in India, a potentially enormous gaming market still at an early stage of the smartphone revolution.

Garena is also a leader in e-sports in ASEAN, providing another opportunity for monetisation but also – more importantly – enabling an extension in the lifecycle of games like Freefire. By building a social community around a select few gaming titles, esports can extend the lifetime of games from 2-6 years to 5-9 years.

The second major vertical for SEA is ecommerce. ASEAN has just 4% ecommerce penetration, even lower than LATAM. Even bricks and mortar retail in ASEAN is woefully underdeveloped, at only c.1/5th the gross floor area per capita that we see in China. This raises the potential of a ‘leapfrog’ to online shopping, skipping the intermediary offline retail stage.

SEA’s ‘Shopee’ platform is the number one ecommerce platform across the region, being 1.4x the size of the next biggest player by Gross Merchandise Volume. It leads in most of the big markets, including Indonesia. Shopee differentiates through: its focus on ‘long tail’ goods which are less standardised and therefore less price comparable across platforms; its unique ‘gamification’ of online shopping (an influence carried over from the Garena side); ‘social commerce’ (allowing shoppers to chat live with merchants); and its rich User Generated Content (high volumes of detailed reviews and ratings, hard for others to replicate). Taken together, these create the ability to command very high levels of user engagement and rising stickiness. As with Freefire, the same golden rule applies: high user engagement means more time spent on the platform, more time means higher likelihood of monetisation.

Crucially Garena is churning out around USD1bn in cash per year, about the current rate of cash burn for Shopee (which is still in investment phase). This ability to fund build-out in the network is a major competitive advantage for SEA. Yet there is visibility on Shopee’s path to monetisation. Shopee is now profitable in Taiwan (where it is most dominant); it is increasing its commission rate in other markets too, as it begins to consolidate leadership. We anticipate breakeven for Shopee is a few years away.

A final point we should mention is digital finance, a far bigger market size than gaming or even ecommerce. 'SeaMoney' is still small, but we are seeing early evidence that it may be gaining some traction. In the last reported quarter, roughly a third of transactions on Shopee's Indonesia platform involved SeaMoney. As we learned from MELI, a payments business can grow very fast when it benefits from the 'launch pad' of ecommerce because the latter provides a very compelling immediate 'use case' for the customer. Moreover, unlike MELI, SEA can also use its gaming business as an additional recruiting tool for payments.

We accept that there is quite a wide range of outcomes for SEA, and we have reflected that in a conservative position size of around 2% for both the Global and Asia funds. What we do know at this stage is that this is a business with real competitive moats, and that there are several enormous growth drivers available to it. Will SEA be able to capitalise on all of these opportunities? Probably not. But we think that it is likely that enough of the variables will fall into place to create attractive, possibly very attractive returns.

ESG: The Importance of Business Resilience

It is volatile times like these that the one must increasingly turn to the non-financial elements of a company to understand how it will fare and in what state it will emerge on the other side. It is nigh on impossible to paint a real-time picture of what the financial situation of most companies will be in the coming months. However, we can be reasonably confident that those that have demonstrated a clear commitment to environmental, social and governance concerns should find a smoother road through this. Not only are these firms more likely to have considered long-term risks within their operations, but they should also enjoy greater access to capital markets and a more engaged workforce, gelled together by strong corporate culture. The latter will be particularly critical in the long weeks ahead of social distancing and remote working, as we ourselves can attest!

This is all part of the softer element of business resilience, a topic that we had picked up recently as part of our work on physical climate risk and specifically how extreme weather events can have potentially catastrophic consequences on certain businesses. As per the Intergovernmental Panel on Climate Change (IPCC), resilience is "the ability of a system and its component parts to anticipate, absorb, accommodate, or recover from the effects of a potentially hazardous event in a timely and efficient manner." Importantly, it is also a measure of the system's ability to adapt, reorganise, and evolve into more sustainable configurations that will leave it better prepared for future shocks.

Understanding how well prepared a company is can be very challenging from the outside as there are no public disclosure standards for these things. As such, we have begun creating our own assessment framework to understand what resilience measures companies have in place across the value chain. It focuses on identifying vulnerability points and understanding what measures a company has in place to manage them. Originally, this questionnaire was designed to apply to companies that might be exposed to physical climate events, but in light of recent events we can now see a much wider application. We will be building this out over the coming months, no doubt armed with some great case studies dished up by the ongoing dislocations.

We have just published our annual ESG Review to frame our wider efforts. The report details how ESG at Arisaig has evolved from engagement on basic aspects of corporate governance some twenty years ago, to our current holistic approach which includes social and environmental aspects. It covers some

of the most pressing long-term sustainability risks for our strategy (plastic waste and climate change) and explains how we have upgraded our own systems in order to improve our monitoring and engagement capabilities. We include examples of engagement over the past year, some of which have been successful, others less so. Copies of the Review are available upon request.

Arisaig Africa Fund Closure

The Board of the Africa Consumer Fund took the decision in February to suspend the NAV due to concerns about liquidity. The following month, shareholders voted for an orderly wind-down at a Special Meeting. And as of writing more than half Fund's AUM had been liquidated and returned to our investors.

Clearly this is a disappointing outcome. As regular watchers will be aware, liquidity in Africa has always been a challenge. This meant that as redemptions were made in the Fund over the years, the least liquid holdings became progressively larger weightings. The issue crystallised in February when a small sub-set of these very illiquid holdings ceased to trade in a manner where the Board could be comfortable that the share prices represented the intrinsic or realisable value of the assets. The stocks in question were Unilever Ghana and Tanzania Breweries, which together amounted to c.18% of AUM. Given the material weighting of these holdings in the Fund, the Board of the Fund suspended the NAV to ensure the fair treatment of all shareholders.

We continue to believe that the continent of Africa presents long-term opportunities for investment returns on account of demographics and the very early stage of development for major consumer-driven industries. However, our experience to date suggest that very few companies are actually capturing this growth sustainably. Consequently, a successful regional strategy would require a highly concentrated portfolio. Unfortunately, such an approach is simply not viable in the context of increasingly illiquid markets and a pooled capital base.

Accessing the shallow African public equities market is, we think, best done through our Global Emerging Market Fund, or our soon-to-be-launched Next Generation product (see below) where improved diversification can be achieved.

Regular readers will know we have written at length about the mistakes we have made in Africa and there is a detailed report available to investors upon request. Perhaps the most important was that of transferring the wrong lessons from our successes in Asia. Whilst many of our MNC subsidiary holdings in Asia are exceptionally well-run businesses, this does not necessarily mean the equivalent is true in other geographies such as Africa. Granted, Africa is home to some notable exceptions such as Nestle Nigeria, but unfortunately the listed subsidiaries of Diageo, Unilever, Danone et al. on the continent are not of the same high calibre. When dubious business quality is combined with illiquidity, these shortcomings are greatly exacerbated and there has been nowhere to hide.

When ultra-high business quality is combined with illiquidity, scarcity value can often enhance the attractiveness of these assets. Fortunately, outside of Africa the liquidity of high quality businesses has tended to increase over time as they grow. As an example, when we first invested in Britannia in India we took a 10% stake with the stock trading little more than USD100k per day. The stock has subsequently delivered 10 year USD annualised returns of c.30%, has grown to a c.USD8bn market cap and now trades on average c.USD20m per day. Businesses like Philippine Seven and Trent, for

instance, have been major drivers of returns for the Asia Fund and we remain confident that their quality will ensure that they will also outgrow their illiquidity in due course.

We have written a short white paper on how we think about liquidity for our other funds, which we are happy to share with investors.

Arisaig Next Generation Fund Launch

We often describe Arisaig's role in the world as that of delivering attractive returns to shareholders through the sustainable growth of our holdings. Our longstanding integration of ESG into our investment process forms a core part of this holistic view on what 'sustainable growth' really means to us.

With that in mind, it was natural for us to take this one step further through a dedicated product which combines the twin objectives of delivering financial returns alongside positive social and environmental impacts.

We believe this is a particularly appropriate fund for Arisaig, an emerging markets listed equity specialist, to be launching, since the countries on which we focus represent the world's largest populations who are most in need of investment into essential goods and services such as healthcare, education and basic financial products. And it is often profitable, publicly listed companies with proven business models which are most effective at meeting these needs at significant scale over the long-term. The current absence of these essential goods and services represents a huge growth opportunity for our portfolio of companies to fill, particularly in the emerging market context where state provision is often lacking.

Our universe is built to target six themes, under which we see overlap between significant developmental benefits and growth opportunities for private sector businesses: health, financial inclusion, education, employment, gender equality and the environment.

Following an 18-month research process, the next generation of Arisaig Partners will be launching its Next Generation Fund in Q2. The research process is led by David Lanning and the Fund will hold around 25 businesses from across the emerging world. Crucially, all of these holdings have financially strong business models, meaning they have the ability to reinvest in their own growth at high rates of return. This creates an efficient, self-sustaining model for amplifying positive impact as these businesses scale. Most are still relatively small companies today, but we feel have the ability to become very much larger in time.

The objectives of the fund are to target both financial returns and the achievement of positive impact. We are very deliberately targeting businesses for whom strategies for optimising shareholder returns go hand-in-hand with the expansion of benefits to society as a whole. These companies will typically be using their economies of scale or technological advantage to drive affordability of their product, thus capitalising on increased accessibility among previously neglected populations at the bottom of the pyramid. This is not a niche opportunity: for example, India spends around USD60 per capita on healthcare per year, compared to USD10,000 in the USA or USD4,000 in the UK. Even in relatively 'middle income' territories such as Mexico and the Philippines, roughly two thirds of the population are 'unbanked', representing huge potential markets for digitally native disruptors.

Readers are welcome to contact Ed Poulter, our Head of Business Development, for more information, or to arrange a call with David. Encouragingly, we so far have around USD75m in commitments, and are proud that this product will enable us to build on our existing track record of ESG engagement, and begin proactively supporting businesses already making a positive impact across the developing world.

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