

Monday, 12 April 2021

Our three Funds all ended the quarter down between 4 and 6%, with a positive start to the year reversing course around mid-February.¹ Given the strong showing over the past year, it was in truth not a great surprise that we would hand back some relative performance at some point. Of the many explanations swirling around for the deterioration in sentiment in recent weeks, a few are most relevant to us. First is the tightening of liquidity in the Chinese market (following a boom in retail investing and mutual fund formation last year), accompanied by fears of a potential regulatory squeeze on US-listed tech stocks from Chinese authorities and the SEC. Second is the broader rotation away from 'growth' companies, particularly those that outperformed last year. Finally, the resurgence of the virus and appearance of variants has clouded the short-term outlook across several markets, most notably Brazil and India.

Despite the predictably messy vaccine rollout and pandemic management across most of the world (developing markets often performing no worse than OECD countries), for the most part, our companies are back to business as usual in terms of operating results. Even those which benefitted most significantly from the enforcement of lockdowns have shown no let-up in terms of their reported results, despite the elapsing of their most favoured status in stock market terms.

We have no particular insight on inflation, yield curves, or the relative prospects of the growth versus value 'factors'. We might venture to say that the latter dichotomy feels like something of a false choice given that it is hard to see how value can be assessed independently of growth. For instance, our largest holding as a firm, JD.com, we expect to grow earnings at an annualised rate of 30% over the next five years, implying it will trade on an EV / EBITDA of 7.5x at the end of this period. Is this a growth stock or a value stock? Does anyone care? Do these labels really matter?

If we had to speculate, one possible outcome of all this is that we see a shake-out in which markets show greater discrimination between 'true quality', sustainable growth businesses, and more questionable 'growth-at-any-cost' concept stocks that were lifted by the general rising tide of digital euphoria last year.

In any case, we see these rather tiresome debates as being essentially tactical in nature. We try to shut out the noise and instead remain focussed on strategy – namely our objective of capturing the mega-trends that will shape the world over the coming decades: sustainable EM domestic demand growth, digitalisation and decarbonisation. We aim to do this by owning a small number of the highest quality 'purposeful growth' businesses.

With that in mind, portfolio activity has been fairly limited in the year-to-date, with most of our attention turned to the weightings of existing positions. For instance, in our Global Fund we bolstered our core FMCG holdings in India such as Godrej, Dabur and Pidilite. Whilst a great deal of attention has understandably focussed on the development of digital platforms over the course of the pandemic year, these everyday staple businesses have also been quietly progressing through building new capabilities (e.g., in e-commerce channel management and digital marketing), as well as launching new and highly scalable categories in line with shifts in consumer demand (e.g., Godrej's entry into hygiene, home and surface care).

¹ Performance referenced net of fees and in USD.

For the Asia Fund, with a higher pre-existing allocation to our core FMCG holdings coming into the year, we took advantage of capital market volatility to further concentrate on our highest conviction names. JD.com has been the main destination for our limited reallocations as evidence continues to emerge supporting our thesis that the company has a strong right-to-win in the large and highly fragmented USD1.8th Chinese grocery market. We have also been encouraged by the fact that after years of persistence, the company is beginning to engage with us on ESG issues (we have specifically discussed data protection, climate change and the circular economy). ESG is now being considered at the board level, and specific sustainability reporting should follow in the coming months. Having long displayed a healthy obsession with customer service, we interpret these latest conversations as a sign that JD is beginning to develop a more sophisticated understanding of its impact on all stakeholders.

On the other side of the ledger, we have worked to trim some of the lower conviction holdings at the tail ends of our portfolios. For instance, the Global Fund disposed of our South African holding AVI, a consumer conglomerate, on account of diminishing expectations for organic growth in its home market. Whilst we are great admirers of the business and its management, we believe there are more compelling growth opportunities elsewhere. The end objective of these changes is more concentrated portfolios built around the very best purposeful growth enterprises, businesses that earn the right to grow forever through their emphasis on creating value for multiple stakeholders. We discuss the question of concentration in more detail below.

B Corporation and Net Zero Update

As an independent, partner-managed business, we have always had the freedom to focus on long-term value creation, and the incentive to strengthen the chain of alignment from our clients, through us, to our holdings. This is reflected in various aspects of how we run our business: for example, the introduction of a longevity rebate to our fee structure, and our reinvestment of 100% of partner dividends into the Arisaig funds. We aim to embody the purposeful growth ideals we seek in our investee companies, and to hold ourselves to the same standards we expect from our partners a step down the chain of alignment.

In pursuit of this goal, we looked for 'official' assessment of our value to all Arisaig stakeholders through our application for B Corporation status towards the end of last year. We were delighted in Q1 to receive confirmation that we have qualified. A summary of our assessment by B Lab (the governing body of the B Corporation certification) can be found [here](#). Among our strengths were the relative diversity of our workforce (54% female); our measuring and offsetting of carbon emissions since 2010; and our alignment of interests with clients.

We are wary that, amid the proliferation of investor certifications, particularly in the field of sustainability, there is a danger of investment managers simply collecting the various scout badges on offer while changing very little about their underlying approach. We have, however, found the B Corporation process to be thorough and thought-provoking, highlighting useful areas for improvement, such as the formalisation of recruitment policies, systematic incorporation of client feedback, and potential to improve the environmental footprint of our office premises. And this is far from a one-off programme: B Labs will check in with us every three years to ensure we continue to justify our certification, and track on our progress against current areas of weakness.

Similarly, we believe these industry associations are worthwhile for tackling the most pressing challenges such as climate change. Hence our decision to become a founder signatory to the Net Zero

Asset Managers Initiative last year. Towards the end of the quarter, we welcomed the news that the further members totalling 23 trillion in AUM have now signed on. This significantly enlarges the pool of asset managers (to roughly a third of the overall industry) committed to both 2030 targets consistent with a 50% reduction in emissions, and to net zero emissions by 2050.

It is disheartening but unsurprising to see the beginnings of a backlash against this change in tone from the asset management industry regarding climate change. Most objections seem to broadly conform to the argument that 'ESG alone cannot solve this systemic issue'. We agree, but do not see the necessity of further government action as mutually exclusive from the requirement for asset managers to begin recognising the existential threat that climate change represents. Just because traffic lights, road signs and drink driving laws are all still necessary, that does not render seat belts pointless.

Each link in the chain plays its part. Far better for the owners and agents of capital to signal to the corporate world that climate outcomes matter to them as shareholders, than to continue ignoring the long-term consequences of a short-term fixation on shareholder value.

As we aim to meet our own commitments, we have been encouraged by the progress of our engagements with our zero-rated holdings according to the Transition Pathway Initiative (i.e., those which fail to report at all on climate change policies and targets). We have already engaged with half of these companies on climate change specifically. As part of our 2023 targets, we aim to push all holdings to at least level two on this scale (basic climate change reporting). The 25 or so businesses currently at level zero should already be reduced in number once individual company sustainability reports start trickling in during Q2.

Concentration

We wrote last quarter about putting purposeful growth into practice as an investment strategy: developing on our own ability to successfully execute 'endurance investing', while focusing on those businesses in emerging markets which take a long-term, multi-stakeholder approach to value creation. We have worked on putting more flesh on the bones of these principles in an updated investment philosophy document (please ask if you would like a copy).

As part of this work, we revisited some of the principles we believe have contributed to our returns over the 25 years of our history. One of these was concentrated portfolios – a defining factor of our funds for at least the last decade. We discussed last quarter how we have evolved our approach to finding the right companies to invest in. Over the last few weeks, we have been re-assessing whether the manifestation of our research and decision-making has been translating into the right portfolio configurations.

Happily, our analysis concluded that our 'batting average' for finding good stocks has been consistently healthy. Of the 39 investments we made in the Asia Fund over the past decade, 24 outperformed the broader Asian market.² This 'hit rate' of 62% is a bit better than the industry average

² Source: Arisaig Partners, Bloomberg. Past performance is not an indication of future performance. Asia Fund performance quoted from March 2010 to December 2020. Batting average defined as the percentage of positions having achieved excess returns over their relevant benchmark over the holding period.

of 50-55%.³ Our average positive alpha (42%) was also significantly greater than the average negative alpha (-17%) of the 15 stocks we selected which underperformed. Albeit on a much shorter time horizon, our Global Fund shows a similarly satisfactory hit rate (68%) since its change in strategy (selling out of Western multinationals) in 2017.

Our record on position sizing, however, is mixed. Of 24 new holdings introduced over the last decade that generated alpha, only eight entered the portfolio as full-sized positions (defined as larger than 3%). The tentative nature of these entries could be argued to have cost us performance, since evidence suggests that our research calls are more often correct than not. Nonetheless, despite our risk aversion concerning new holdings, overall our position sizing has enhanced alpha. An equally weighted, yearly rebalanced version of our Asia Fund would have returned 326% (gross) in the last 10 years (vs. 129% for the MSCI Asia ex-Japan Index). Actual gross returns were 462%, suggesting position sizing added an incremental 136% in performance over the period.

One other criticism of our portfolio construction is that our top twenty positions have generated more than 100% of positive performance in up years, and, on average 3% more in returns in down years. Our definition of concentration over the last decade has been 20-30 holdings; in hindsight 20 would likely have been better than 30. In the relatively volatile world of emerging markets, we have tended to see the relative diversification of 30 names as a less risky interpretation of our belief in the need for high-conviction, genuinely active portfolios. Evidence suggests, however, that our tail positions have generally detracted from performance, and we should have paid more attention to Charlie Munger.⁴ Truly, our 29th best idea is likely a far inferior destination for our capital than additional investment in our top 20.

New Holding: IndiaMart

All three of our funds have taken a position in IndiaMart, India's leading B2B online marketplace. With a 60% market share of B2B e-commerce, IndiaMart's platform provides virtual storefronts to six million MSMEs – typically small suppliers of products such as industrial machinery, construction materials and apparel. These suppliers pay a subscription fee to access the 70 million registered buyers looking for specific, specialised merchandise. Much of the company's competitive advantage, we believe, lies in the highly detailed cataloguing of these 'unfinished' goods; as well as in the assembly of a trusted nationwide base of merchants. Many MSMEs operate on both the buying and selling sides of the network.

The business is broadly comparable to Alibaba's 1688.com division, yet at a far earlier stage of development. IndiaMart's revenues of around USD90m are for now dwarfed by the size of 1688 (USD1.5bn). Scale should bring increased profitability for IndiaMart (1688 enjoys EBITDA margins over 50%), but given its intrinsically asset-light model, IndiaMart is already generating very healthy economics (ROCE of 58%). We do not expect major margin uplift in the short-term, as over the next few years management will focus on reinvesting in scale and functionality of the platform. IndiaMart remains, for example, far behind 1688 in terms of technological capability, as well as the offer of

³ Novus, in its memo "How to identify Top Hedge Fund Managers Using Public Ownership Data", notes that most managers' batting averages are around 50-55%; there are also numerous other sources pointing to this statistic.

⁴ In his own words: "The whole secret of investment is to find places where it's safe and wise to non-diversify. It's just that simple. Diversification is for the know-nothing investor; it's not for the professional."

incremental services to its merchants such as payments, tax invoicing and basic management software.

Indeed, this is a business which beyond tackling the full extent of its potential TAM (recruiting more of the circa 60 million MSMEs in India as subscribers) enjoys a great deal of 'optionality' to grow into additional business adjacencies. Asset-light digital platforms are perhaps uniquely privileged in this respect – able to 'bolt on' value-added services in order to monetise more stages of the customer journey.

IndiaMart's biggest threat is from deep-pocketed 'horizontal' e-commerce players who may look to expand into B2B e-commerce. Amazon, for example, already likes to trumpet its usefulness to SMEs in India, claiming to represent 400,000 sellers – though a recent report revealed its top 35 vendors accounted for around two thirds of the value of goods sold on its marketplace. IndiaMart, in contrast, caters for a highly fragmented base of suppliers and buyers. Perhaps a closer competitor is the local B2C marketplace Meesho, recently funded by SoftBank, whose expertise in social commerce more closely mirrors the MSME constituency core to IndiaMart's operations.

We wrote last quarter about how purposeful growth businesses create multi-stakeholder value; as a result they endure and continue capturing growth opportunities over the long-term, amply rewarding shareholders along the way. IndiaMart, still controlled by its founders, was established to solve an obvious problem facing Indian businesses: offline procurement is time-consuming and lacking in price transparency. Other online channels are not optimised for B2B buyers and sellers. The company's mission is to make it easier for MSMEs to do business; to empower many of them to move online for the first time; and to enhance outcomes for both buyer and seller by matching them algorithmically from a much larger network than either would encounter offline. If it continues to succeed, we are certain this business will be worth many multiples of its current value over the next decade.

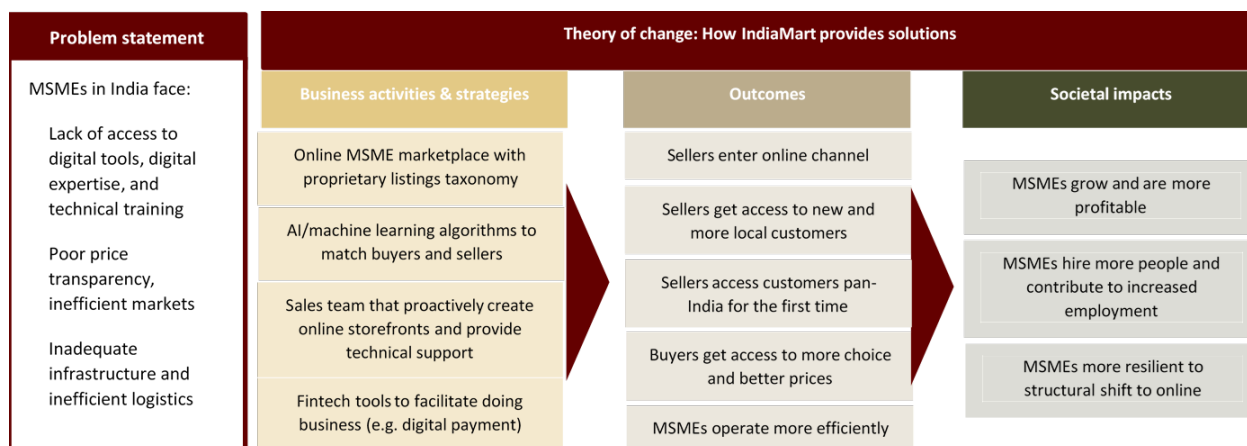
Impact Assessment

To qualify for the Next Gen Fund, which invests for both social outcomes and financial returns, we assessed whether IndiaMart's core business contributed positive impact under one of the six themes targeted by the Fund (Health, Education, Employment, Environment, Financial Inclusion and Gender Equality). Under the 'Employment' theme we consider companies whose core activities empower MSMEs, a particularly crucial source of jobs and financial stability in many emerging markets. This theme carries particular weight in the Indian context, since the country is adding 12 million people annually to its working age population until the peak of its 'demographic dividend' in the 2030s. India needs to more than match that number in terms of job creation if its demographics are to become an economic asset, rather than a social liability.

Even once a business has met the basic initial qualifier for this strategy (that its core business generates positive impact under one of our target themes), some companies hold far greater potential than others to enhance social outcomes, sustainably and at scale. To apply similar standards of rigour to this analysis as we would in a conventional investment analysis, we have developed an assessment methodology which attempts to gauge both the current and future social impact of each target company we consider.

As the foundation of each impact case, we identify an initial 'problem statement' under one of our impact themes, and a 'theory of change' for how the business in question contributes to the resolution of this problem. In IndiaMart's case the pathway seems clear: by enabling MSMEs to adapt to the

online channel shift and operate more efficiently, the company helps make these crucial sources of employment opportunities both better able to grow in the short-term, and more resilient to the rise of e-commerce over the long-term.



In the next part of the process, we conduct a fuller company analysis (please ask if you'd like to see an example) under the [five dimensions of impact](#) as described by the Impact Management Project (a community of impact investors advancing best practice and standardisation). We identify key risks to the impact case, both directly related to the alignment of impact and financial goals, and to broader ESG risks such as governance and climate change. We also proactively identify key engagement priorities for each company in order to maximise our own potential to contribute to positive social outcomes as investors.

For each different business we study, impact KPIs will differ substantially, though naturally there is more potential for overlap within our designated impact themes. In the case of IndiaMart, we track the number of registered suppliers on the platform (as an example of the Reach of the business); the proportion of its customer base hailing from lower-tier cities (as a proxy for Criticality, i.e., the underserved nature of its market); and customer satisfaction and churn (as indicators of service quality, or Effectiveness). Enhancing disclosure in these areas is often a key priority of our engagement efforts across our portfolio.

Finally, we grade each business (on a 0-6 scale) under each of these three categories (Reach, Criticality and Effectiveness) to achieve some level of comparable, standardised measurement for different holdings across impact themes. Given its already large customer base, the urgent need for support of MSMEs (and more and better employment options) in India, and the quality of IndiaMart's service relative to competition, it scores fairly highly on our framework (average 4 out of 6). Importantly, there is a clear pathway for the business to take these scores higher by both continuing to expand the reach of its services, and more directly targeting and evidencing the positive outcomes of its products on India's millions of MSMEs.

Conveniently, we tend to find that those companies in our universe with the highest impact potential correspond closely to those with greatest scope for financial growth. Our chosen focus themes represent significant 'white spaces' for companies with profitable, scalable business models which can address the vast untapped markets among low-income populations across the emerging world. Much as in the case of IndiaMart, it is often technology which enables them to occupy these spaces without compromising on affordability or quality.

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