ARISAIG QUARTERLY JULY 2021

Friday, 09 July 2021

Our Funds recovered substantially in the second quarter after a muted start to the year, with our Asia and Global Funds gaining 3.4% and 5.3% respectively. The Funds are now down 2.3% and 1.0% year-to-date. Our impact investing strategy, the Arisaig Next Generation Fund, gained 11.0% in the quarter and is up 6.1% year-to-date.

Please keep your eyes peeled for our inaugural impact report later this summer. Across all strategies, we have also taken the decision to replace our annual Portfolio Review document with a presentation given by the partners in late July. An invite with further details should reach your inbox in the coming weeks.

For many of us sitting in highly vaccinated countries, it can be tempting to imagine the imminent return of pre-pandemic normalcy. Of course, our investments are almost exclusively in countries in a less fortunate position. At the time of writing, only China and Chile in our investable universe had administered more than 50 doses per 100 people (roughly half the rate of the US and UK), with most nations languishing far below this level. One of our three offices is in Mumbai, where since our last bulletin the COVID situation has deteriorated substantially. Vaccines will come, eventually, but persistent reservoirs of infection may leave the gates open to new variants. The road will be bumpy for some time yet.

Behavioural edge

A year ago, we found ourselves striving to avoid 'COVID meltdown' noise. Today, there is an array of discussions on 'the reopening trade', factor rotations, short-term inflation pressures, and the cadence of Fed 'tapering'. These factors may have played some part in the rather lacklustre relative year-to-date performance of our Global and Asia strategies; but the simple truth is that we don't know.

Indeed, there are very few things in life that are 'knowable', which is why we choose to focus our strategy on a simple premise which, if not strictly knowable, is at least highly probable. We believe that over the coming decades, the engine of global economic growth will be domestic demand in Emerging Markets, and that well-run, defensible businesses with purpose at their core are more likely than others to capture that growth in a sustainable, predictable way. It is for this reason that we must be very clear about what are the more knowable things that we have at least some chance of understanding, and what are the less-knowable things that are best left for others to worry about.

With the above in mind, whilst stock price fluctuations come and go, what really matters to us is the underlying fundamentals of our portfolio companies: this is ultimately the most knowable and visible evidence of intrinsic value creation. As we never tire of saying: earnings growth drives returns in the long-run. In this regard, we are sanguine, with both reported earnings and management commentary coming out as generally positive and ahead of expectations. We estimate that our Global strategy's holdings should deliver aggregate earnings growth of 24% over the next 12 months, and 22% annualised over the next five years. Those earnings can be re-invested at an estimated portfolio average Return on Capital Employed of 39%: a phenomenal number. And yet the Fund is more-or-less flat year to date.

This disparity between weak stock price performance and strengthening fundamentals is perplexing. For instance, our Chinese internet names have all suffered share price weakness on account of renewed regulatory scrutiny of this sector. Whilst this is not a risk to take lightly, the blanket sell-off in the sector appears rather indiscriminate.

JD.com, for example, continues to display impressive operating momentum, with sales on track to grow around 30% this year by our estimates. Looking longer term, this company is making a credible claim to be the dominant player in Chinese grocery ecommerce, an enormous chunk of overall consumption in China, and the last one yet to move online in a big way. We think that JD has a clear advantage over rivals here thanks to its integrated and fully self-managed logistics capabilities. Whereas an offline big box retailer might have 10-20,000 SKUs, JD offers 8 million. 90% of orders fulfilled by JD Logistics can be delivered on the same day or the next day to 500 million customers. The fact that JD has just 30 days of inventory tells us that this is a highly-optimised fulfilment chain. It is very hard to be both fast and efficient, and in order to achieve this it is necessary to know what inventory to hold in which warehouse, and when to hold it ("right place, right time, right person"), a highly information-intensive challenge. The only other retailer that comes close to being able to manage that level of complexity is Amazon, and indeed these are capabilities that are very hard to replicate, taking decades of painstaking investment, trial and error testing, and data accumulation.

Moreover, far from being some sort of 'victim', this company is most likely a beneficiary of tighter regulation in this sector. A recurrent message running through JD's recent investor day was that of "deep purpose", the objective being to create shared value for a broader ecosystem of customers, merchants and employees. As we describe in the next section on "Navigating China", this form of alignment with the strategic objectives of the government is a very China-specific way of conceptualising ESG, and essential for all businesses that operate in this country to get right.

It has taken us many years to build up confidence on this name, and this was not a straightforward process for us. We began our due diligence on JD back in 2016 before investing in 2018. Speaking candidly, the next two years were very challenging from a behavioural investing standpoint. The stock price gyrated as the market fixated on quarterly results prints which, at face value, were mixed. Whilst the company was growing revenues and was operating cashflow positive over this period, it was also generally loss-making at a net level, having made the decision to re-invest aggressively in order to build scale and develop the world-leading logistics capabilities we mentioned above.

The fruits of these initiatives are only now becoming apparent. Despite continuing aggressive re-investment, the power of scale leverage has been such that the company is now comfortably profitable, with operating profit of USD1.8bn over the last twelve months (a margin of 1.5%). Although hindsight is a wonderful thing, and we obviously could not be certain that today's reality would be the eventual outcome for JD when we were assessing this a couple of years ago, we nonetheless felt that this was the most probable long-term destiny for the company. Meanwhile, the market was focussed on quarterly earnings versus 'street' expectations as opposed to thinking about the far greater long-term intrinsic value that would result from JD's dogged commitment to reinvest. For this reason, we topped up our position in the company back in late 2018. As fundamentals strengthened over the course of 2019 and 2020, so followed the share price.

Fast forward to the present day, and we see once again a share price decline which appears divorced from the fundamentals. JD's shares are down 19% year-to-date from not particularly lofty valuations. Today our in-house DCF tool, the Arisaig "Crystal Ball", projects around 14% long-term (20-year) returns. On a shorter-term view, the stock is trading at 15x FY23 EV/EBITDA. Both the Asia and the Global Funds have taken this opportunity to further increase our positions.

Again, returning to what is 'knowable' – there are close to a billion internet users in China. On average they spend c.4 hours per day online; 25% of retail spending is already online (it seems entirely plausible that the majority will be in the not-too-distant future); and China is re-inventing itself as a domestically-focussed consumer economy with innovation and digitisation acting as catalysts (this is not speculation, it is explicit government policy). This points to a very strong likelihood that the theme of digital consumption will be one of the defining features of China's economic development over the coming decades. The logical follow-on is that owning the best-quality, highest-growth operators in this space (in our view: JD.com, Meituan and Alibaba) absolutely must be a keystone element in our investment strategy. This is about as close as we can come in the field of investment to what is truly 'knowable'. This seems far more relevant than any discussions on short-term factor rotations or trying to catch some fleeting bounce in beaten down old economy stocks!

All of the above is to say that for long-term investors such as us, periods such as the past six months – lagging share-prices combined with ever-strengthening fundamentals – are times of opportunity. This focus on strategy not tactics, and a capacity to suffer through share price volatility, is the essence of a behavioural discipline which we term 'Endurance Investing'. Whilst the notions of behavioural edge and time-horizon arbitrage are quite widely known, we believe that surprisingly few investors can follow through on this approach, mainly because incentive structures and performance measurement in our industry are so skewed towards the short-term. As we learned with JD in 2018, and as we are being reminded today, holding one's nerve, shutting out the noise, and continuing to behave rationally during rough markets is not easy, but is precisely what we are paid to do. We are privileged to have a base of end investors who understand all of this, and have been rock solid over the course of this year. Indeed, we have enjoyed positive inflows across all three of our strategies. This alignment with our clients is ultimately what gives us the psychological comfort that makes endurance investing possible.

Navigating China

Building on our own experiences from a quarter of a century investing in and engaging with holdings in China, this year our team has spoken with numerous local ESG practitioners and experts in order to build a comprehensive blueprint for analysis and engagement in this increasingly important market. Please contact us if you would like to see a copy of the full report.

As we alluded to above in reference to JD.com, a key consideration of investing in China is that corporate objectives align with those of the government. Navigating ESG issues requires a tailored approach across all our key emerging markets, but China is perhaps most distinctive. Materiality here is more closely correlated to government priorities than anywhere else.

The need to filter governance analysis through a prism of SOE interests is well known; less well appreciated, though brought into sharp focus by the recent wing-clipping experienced by some of the tech giants, is the widespread party influence even within nominally private firms. 93% of China's top 500 private firms contain some form of CCP organisation.

The prominence of environmental and social issues, therefore, inevitably follows to some degree the policy changes indicated by each Five-Year Plan. This explains the increasing confidence of private Chinese companies in joining the drive to reduce the carbon intensity of their operations, as the national government deepens its commitment to tackle climate change. If we adhere to the common characterisation of CCP policy as seeking the balance between growth and control, then most individual private industries can be viewed as individual microcosms of the same phenomenon. The growth of private companies is to be celebrated, until their activities begin to threaten social stability.

The private tuition business is a classic example of this. Increased access to high quality education is certainly positive to Chinese development goals. A relentless customer acquisition drive by VC-backed online education businesses, raising stress, competitiveness and costs for all families, is not. The government's understandable desire to rein in these negative consequences of unrestricted growth now threatens an indiscriminate regulatory clampdown against the entire sector, and was a key rationale for the decision to downsize our position in New Oriental in the Next Gen Fund.

This pervasive state influence is certainly not always obstructive to private businesses. To a Western audience, it may be surprising that the poor labour conditions faced by delivery workers for Alibaba's on-demand platform, ele.me, are perceived by consumers as overwhelmingly a public policy issue (ie. "How could the Government let a situation like this occur?"); rather than a case of loophole-exploiting irresponsible capitalism (contrast with the ongoing gig economy regulation battles fought by the likes of Uber and Deliveroo). This does not make intrinsically unsustainable operations any less risky over the long-term, but certainly influences the urgency and nature of specific social risks.

The prominence of 'top down' sustainability factors does not, however, render ground-level influence irrelevant. Chinese consumers, for example, have shown themselves to be more concerned by food quality and safety than in any other major market, a factor which has heavily shaped the respective performance and development of the country's restaurant industry. The Chinese are at least equally drawn towards healthy and 'natural' products within the F&B sector as their Western counterparts. This has been driven both by high profile lapses from major consumer brands; but also by an organic trend towards appreciating the more gradual health risks of excessive consumption of sugar and processed products.

Engaging with Chinese businesses is not straightforward, particularly among those wary of over-indulging the (often quite short-termist) priorities of foreign shareholders over other stakeholders more critical to long-term success. Happily, our style and philosophy lends itself to a patient approach and the development of relationships with our holding companies over several years. We believe it is no coincidence that many of our most meaningful engagement successes in China have followed a period of multi-year ownership.

Thesis Revisit: Arco Platform

Our Global and Next Gen Funds have increased their exposure to Arco Platform, a Brazilian education business listed originally in 2019. Arco's core business is that of digital 'learning systems', a comprehensive content solution for schools which provides teachers and students with learning materials and digital tools for lesson planning, teaching and assessment. The company replaces a traditional system of printed textbooks and analogue communication between teachers, students and parents, with a subscription-based integrated digital solution, able to update in real time in line with changes to the syllabus, optimisation of content (based on data feedback loops), and which can be customised to individual pupils.

We believe there is a powerful incentive for schools to switch from current systems to this more effective, typically less expensive solution. Once Arco's tools are integrated into a school's operations, however, the disruption that would be caused by discarding them is a similarly powerful deterrent against switching to competitor products. Arco's customers are private schools, which account for roughly a fifth of students, with average tuition costs of roughly USD185 (monthly) making this a more habitual purchase than might be the case in the US or UK. Content costs are typically passed onto parents, and Arco's digital solutions both save parents money compared to traditional learning systems, and achieve better than average learning outcomes, based on the ranking of Arco schools in standardised national exams.

Indeed, raising education standards is at the heart of the company's mission, making Arco a good illustration of the 'Purposeful Growth' culture that we seek in our investee companies. Its roots are in the management of a series of high-achieving schools in the State of Ceará in the Northeast of Brazil.

Its founder developed the company's learning systems as a way of sharing the successes of his family's teaching methods with a wider network of educators. Arco's digital-first model (albeit focused predominantly on improving and facilitating in-person teaching) allows for a highly scalable system which does not diminish in quality as it expands. On the contrary, expansion allows for the reinforcement of 'data moats', in other words the real-time adaptation and update of content and platforms in response to user experience.

Key to the principles of the Next Generation Fund is that for a company to be able to reliably generate and grow its positive impact over time, it must deliver it in a financially sustainable way, which rewards the investors who provide it with capital. Philanthropic dollars at some stage dry up; so for impact to endure, the business in question needs to generate sufficient cash to sustain its own growth. Our goals in this strategy, therefore, of optimising for both impact and financial returns over the long-term, go hand-in-hand when we select the right business models.

In the education space, for example, those companies which show themselves to successfully enhance learning outcomes are most likely to keep on attracting business over the long-term. Schools choose Arco because its system helps improve its own service, thereby attracting parents and students. As a digitally native model, Arco's marginal cost for adding each new customer is essentially limited to the sales force which recruited them, and the customer service representatives who keep them happy. Though ROCE of 17% is currently depressed by a recent major acquisition, we expect incremental ROIC to trend towards 100% in periods of organically-driven expansion.

The main risk we perceive is a relatively limited addressable market. It is no sure thing that private education will continue to increase its share of the Brazilian education system (though chronic underinvestment in the public sector seems like a dependable driver for now). We believe consolidation of the market is a more reliable source of long-term growth, and that Arco's chance of increasing its national market share from its current level of 17% are high. Multiple sources have independently vouched for the superior quality of its offering, and it offers a clear academic benefit and cost saving relative to traditional textbook-based systems. Acquisitions, however, bring added execution risk, particularly given the strength of Arco's culture and purpose, which does not always allow for easy adaptation by newly acquired subsidiaries.

A silver lining to this dependence on acquisitions is the creation of growth optionality and potential expansion of the company's TAM. For example, recent takeovers Dom Bosco and Me Salva! have brought it into the realm of state schools (positive for the company's impact case) and direct-to-student test prep, respectively. Consistent cash generation from the core business will allow Arco to direct sufficient resources to capture these new sources of growth.

The share price has been weak over the past year, as the market is concerned with a slowdown in subscriber growth, with some schools reportedly reluctant to sign new contracts given the uncertainty related to the pandemic. We do not think these are structural issues that affect the real value of the business (indeed, the pandemic has actually re-enforced the utility of digital learning tools), and even after a recent bounce-back (which occurred after we had completed most of our top-up buying) we believe the valuation of the shares still looks very reasonable.

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