Monday, 11 October 2021

- Our Asia and Global Funds were roughly flat during the third quarter, with the Next Gen Fund declining 3%. Asia and Global are both down just over 1% year-to-date, while Next Gen is up 3%.

- A strong performance surge from late August into mid-September tailed off towards the end of the quarter, as Evergrande muscled into the picture and markets globally began to reflect inflation concerns. Broadly, our ASEAN exposure proved supportive to performance for all strategies in Q3, while for Global and Next Gen, Brazil dragged, on fears the Central Bank’s response to inflation will throttle the economic recovery, and amid early signs of political instability ahead of next year’s elections.

- China, however, was the main creator of noise in the quarter, beginning with the broadening of regulatory intervention following the mid-summer clampdown on after-school tuition. Our focus remains, as ever, on purposeful growth businesses, which by definition continue with business as usual as the state clamps down on ‘socially harmful’ sectors.

- Similarly, we have no direct exposure to the Evergrande situation. A resultant slowdown in economic growth would suit no one. But our cash generative, market-leading businesses have historically continued to thrive during downturns as weaker competitors fall by the wayside.

- The most significant drivers of positive performance for our funds in Q3 were our Indian businesses. India’s COVID cases have dropped dramatically since the midpoint of the year and vaccinations are gathering pace. Much of our current research activity is focused on the flood of listings in the technology space here. So far, we have made no new moves, finding insufficient business quality to displace our existing holdings (particularly given highly aggressive listing valuations). But we do see promising candidates in the pipeline.

- The Next Generation Fund has now passed the one-year mark. So far, focusing on businesses which generate positive social impact, has also proven to be a sound financial decision. Indeed, our worst performers so far have tended to display a weakening impact case; while the majority of the portfolio has thrived throughout the pandemic, by continuing to deliver essential, affordable products and services, and directly contributing to the development of major emerging markets.

- One highlight from our engagement efforts this year has been our participation in the strategic evolution and growing ESG consciousness of Mobile World, an omnichannel retailer in Vietnam held by our Asia Fund. Though a pioneer in its market, this is still a relatively young business, now beginning to lay firm foundations for the coming decades of growth.
China: Purpose

Both the nature and volume of Chinese policy announcements were already the main driver of substantial volatility across the broader EM universe through July and August. The Evergrande threat and signs of slowing economic activity then added further fuel to the fire. We first presented this chart at our portfolio review call in late August; in the weeks since, we could easily have added several more market-moving events to the timeline on the right-hand side of the picture.

We have little to add on the broader regulatory environment. Our focus, as always, remains on identifying the best purposeful growth businesses in the country, an approach which we do not believe is threatened by the CCP’s agenda. We do not think the government wants to kill private enterprise. It does not want to expel foreign investors. It does not want to strangle the technology industry.

Our focus on purposeful growth as a desirable investment characteristic is predicated on the belief that companies with a core purpose, which create value for all stakeholders, will prove much more capable of capturing enduring growth opportunities, and thus continuing to reward shareholders over the long-term. We expect that businesses which, as they grow, create a growing off-balance sheet ‘social liability’ will eventually be forced to cover this cost in some way – be that through regulation, taxes, or customer backlash over the long-term. The recent CCP clampdowns can arguably all be viewed through this lens – a pre-emptive transfer of social liabilities onto private balance sheets. They are policy-led corrections of negative externalities.
The existence of these externalities is hard to deny. Perhaps the sharpness of share price moves reflects surprise at the suddenness with which the state has attempted to correct these perceived market failures. One might have expected that eventually, the online education sector’s parent-guilting customer acquisition strategy would slowly run out of steam, as educational outcomes failed to justify the cost in terms of fees and stress. One might also have expected that gig economy-reliant platforms would struggle to keep drivers and customers happy as employment conditions failed to improve. The government has simply made the determination that these intrinsically unsustainable situations should not be left to resolve themselves over several years; and that the heavy social cost justified earlier regulatory intervention.

We wrote last year about one of our own portfolio ‘interventions’ whereby we saw the likelihood that negative externalities would be internalised in some form, thus transforming the long-term economics of the business. This was in the dairy sector (more commentary available here). This was the section of our portfolios which we felt was most exposed to climate change transition risk and the eventual privatisation of the social cost of carbon emissions.

We expect that at some point in the future, both tragically late and shockingly soon, carbon costs will be ‘in-housed’ across the board. Our portfolios are already resource-light by wider market standards but we are working on building a carbon price into our long-term valuation models, such that we can attain a more sophisticated understanding of those businesses which will be most advantaged by the inevitable economic recognition of the social cost of carbon.

Again, such an approach would align with the stated agenda of the Chinese government to reach peak emissions by 2030. We do not know exactly how they will achieve this, but can be sure the direction in which the policy gun will point, and that higher emitting companies will closest to the firing line.

China: Growth

It should hopefully come as no surprise to investors that we have not held any exposure to Evergrande, or to any other businesses in the property sector. We therefore have no particular company or sector-level insights into how this situation will be resolved. We do, however, note one key difference to the other policy challenges that the Chinese government has faced this year. All of the industries which have faced substantial intervention thus far have been small enough in size such that the government could neutralise the social cost without triggering a broader economic fallout.

This is not the case in the real estate sector. It is 29% of Chinese GDP. Put simply, Beijing can continue to support construction-driven economic growth; or it can choose to prioritise affordable housing and dampen the risks of overleverage in the sector. It cannot do both; the government is not immune from making hard trade-offs.

We expect the only option is for the government to finish what it has started through its limits on leverage, and attempt to place the industry on a more sustainable (slower growth) trajectory. This will inevitably dampen overall GDP growth barring miraculous levels of expansion in industries with more favourable prospects, such as consumer tech and clean energy.

In such a scenario our companies would not be immune from the fallout. Strong wage growth is undoubtedly helpful for companies exposed to domestic demand. But we expect our portfolio companies would do far better than most. They generate plenty of cash flow, and are not dependent on credit to grow. Their clean balance sheets can withstand an economic downturn. And if the
‘common prosperity’ agenda is successful, the redistribution of wealth to the middle and working classes should help to boost demand for the everyday products and services offered by our companies.

Even more important, and not dependent on policy success, are the ‘dual tailwinds’ our Chinese businesses (and indeed all our portfolio companies) enjoy. They are not singularly reliant on overall industry growth. Instead, they can draw on market consolidation and/or the continued digital channel shift to grab themselves a larger slice of the pie.

Through such times we focus on controlling what we can control – identifying those businesses which can continue to compound earnings growth at a double-digit rate for the foreseeable future. Ultimately this will earn us a healthy return regardless of any short-term derating. Our basket of Chinese stocks (in the Asia Fund) is forecast to grow earnings at a CAGR of 21% over the next five years. And at the end of this period, there will still be ample runway for growth remaining: our long-term DCF model forecasts a weighted average of 12% IRR from these holdings.¹

India: Digital Opportunity

The digitalisation of India will be, in our view, one of the most consequential developments for the global economy over the coming decades – possibly comparable in scale with what has occurred in China in recent years. The nascent digital economy is starting to take shape, but it is generally accepted that just 10-15 million people (i.e. c.1% of the population) are currently driving most of the commercial activity in areas like ecommerce. India’s famously low per capita consumption of most goods and services, combined with a total cost collapse in mobile data (this is now at 1/80th the price per gigabyte vs. the USA) means that the country looks well-poised for a dramatic ‘digital leapfrog’. Given well-known constraints and underdevelopment in legacy offline systems (e.g. India’s formal retail square footage per capita is 1/8th the level of the China) it is not hard to imagine digital platforms occupying, eventually, a greater share of demand than is (or will be) the case in developed countries.

Therefore, we have identified the digital space in India as one of the key strategic areas for our portfolios as we look out towards the coming decade. Across our strategies we have already created a fairly decent spectrum of coverage. This includes IndiaMart (the number one B2B online marketplace); Info Edge (a collection of leading online classifieds sites, and other digital assets); Jubilant Foodworks (‘Dominos’ India – essentially a 1P ecommerce company that specialises in pizza); and SEA (whose gaming division has sizable exposure to India).

We continue to focus considerable research firepower on this area. There have been a number of high-profile IPOs so far this year, with more in the pipeline. So far we have evaluated five companies in this space, but have passed on most of these given that we found it hard to get comfortable on their meeting our criteria of Purposeful Growth. We did not participate in the food aggregator Zomato’s IPO, for instance, on account of uncertainty regarding strategic vision, management stability, and sustainability (both in the financial and broader sense) of the business model.

Growth alone is not enough, particularly in an environment in which local investor euphoria is, for now, leading to the pricing in of blue-sky scenarios for all new India tech listings. That said, we do believe there are one or two promising candidates in this space which may, hopefully, be going public once the hype has had a chance to die down. We expect to be able to provide updates in future letters.

¹ Arisaig Partners, Bloomberg, end September 2021. These are future forecasts and are no guarantee of future performance.
Next Generation Fund: One Year Review

The pooled vehicle of our impact investment fund launched in late August 2020. The idea behind this strategy was to allocate capital towards those businesses helping drive immediate and substantial positive social outcomes in the developing countries we cover. We do not seek ‘ESG best performers’; but instead those companies directly targeting the largest and most urgent areas of need. We believe that identifying business models which can effectively and efficiently scale over the long-term is the surest path to enduring and expanding impact. These businesses have the potential to reach tens of millions of underserved customers, but often operate in relatively shallow financial markets, and stand to benefit from the provision of ‘patient capital’ which can help them expand sustainably, rather than over-prioritise short-term profitability.

We have initially chosen six impact themes, comparable to UN Sustainable Development Goals, under which we believe private enterprise has the most potential to drive positive change in a manner which can also be rewarding over the long-term to shareholders. Our portfolio of companies already impacts a total of 390 million people (720,000 adjusted for our ownership stake at the strategy level), or 14 million expressed as a per company average. Our forecasts suggest they will grow at 15% on the top line over the coming five years; these are overwhelmingly volume-driven businesses committed to improving access and affordability, such that this revenue CAGR figure could also be assumed to be a reasonable proxy for growth in ‘Reach’.

The single biggest mistake we have made so far – our ownership of New Oriental in the Chinese education space – could have been avoided had we been more demanding in our focus on affordability (and thus on business models targeting maximum ‘Reach’ and ‘Criticality’). The after-school tuition industry’s failure to restrain pricing was, after all, a key factor in its sudden downfall.

There are of course no perfectly positive businesses, and all economic activity carries with it some form of negative impact and ESG risk. But optimising for impact could be argued to be a good way of improving financial resilience. COVID has added more weight to this case. The vast majority of our holdings have thrived over the last 18 months, for example by addressing healthcare shortfalls which were brought into sharp focus by the pandemic; by providing everyday digital access to financial services crucial to keeping the economy going; and by helping developing countries with both climate change mitigation and the development of renewable energy. Needless to say, none of these problems are anywhere near solved, and solutions businesses have the potential to benefit both from the structurally higher growth of emerging economies, but also the necessary tilt towards these sectors in the years to come.

Though we are encouraged by fund performance, now 22% since launch, we prefer to focus on the vast runway ahead for our companies, should they stick to volume, affordability and accessibility-driven strategies. While for many of our businesses this means targeting customers firmly at the base of the global income pyramid, this is not always the case. In the Financial Inclusion segment, for example, the most compelling opportunities are often still in basic financial services offered by telcos such as Safaricom and MTN Ghana; whereas in somewhat higher income countries such as Brazil, the most ‘critical’ market segments can be found in basic banking services for small businesses, offered by companies like PagSeguro.

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2 Arisaig Partners, Bloomberg, end September 2021. These are future forecasts and are no guarantee of future performance.
Our bottom-up research process is intended to identify the best examples of high impact, high return businesses across all emerging markets under our chosen impact themes, wherever this might be. Please do reach out to our client services team if you would like to hear more about how our first year has gone; how we think about and measure impact; or anything else. Our inaugural impact report, promised last quarter, should now be available on Citco for Next Gen Fund investors (apologies for the delay). Any feedback on our impact reporting will be gratefully received by the team.

Engagement Highlight: Mobile World

Engagement is a critical part of our role as stewards of capital, with engagement activities accounting for c. 2,000 hours (10%) of our research team’s time annually. We view this entirely as rational self-interest: helping businesses become the best, most resilient possible versions of themselves, including through their management of ESG, such that they can continue to create value over the very long-term.

Many of our holdings, while established leaders in their field, are still relatively immature in a global context when it comes to navigating ESG issues and the long-term development of their industries. One such example is Mobile World, an omnichannel retailer in Vietnam, which we first added to our Asia Fund in 2019 after two years of due diligence. We now own close to 6% of this business.

An opportunity that excited us early on about Mobile World was the potential for it to pioneer fresh grocery omnichannel retail in Vietnam. Having come across a number of innovative and interesting models in South China, we shared and discussed our research with management in Q1 2020. While we do not wish to overstate our role, we believe this contributed to Mobile World’s early thinking on the topic. The company has since proven its capabilities in online grocery, with bachhoaxanh.com recording 520% revenue growth in the first 8 months of 2021 compared to the same period last year, becoming the only FMCG retail chain among Vietnam’s top 10 ecommerce websites.

Importantly, these financial results are underpinned by evident creation of significant value for its customers, making it a prime example of Purposeful Growth: during Vietnam’s recent covid wave and “stay where you are” mandate, Mobile World helped to ensure that hundreds of thousands of people continued to access fresh food and other daily essentials.

Another of our engagement priorities has been for Mobile World to strengthen its incorporation of material ESG factors, such as its environmental footprint, both in strategy and reporting. We saw the company’s first attempt at ESG disclosure (three pages in its 2020 Annual Report) as a way to get a ‘toe in the door’ and commenced an intense period of engagement between May and July this year. This involved multiple rounds of written and verbal exchanges to help the company understand the strategic business case for ESG. This culminated in a gratifying video conference with Chairman Tai, during which he said he finally understood the relevance of ESG for Mobile World thanks to Arisaig. We understand he has already appointed a senior executive to lead on sustainability and look forward to continuing to support the company on its ESG ‘journey’.
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