FSSA
Investment Managers

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Quarterly Manager Views

FSSA Global Emerging Markets Equities Focus

> "Out of adversity comes opportunity."
>
> Benjamin Franklin

Since we last wrote, roughly three months ago, investors in emerging markets have had to reconcile themselves to a stream of disappointing headlines from several key countries. We are often asked about our own views on politics and macroeconomics, and how we incorporate them into our investment process. For over thirty years that the broader team has been managing money in emerging markets, the answer has been the same — our primary focus is on management teams and franchises, not on politicians or macroeconomic forecasts. The reason for this is simple: we do not believe that we, as a team, have strong capabilities in predicting near-term macroeconomic or political events on a consistent basis. This is also why we are sceptical about any investment case that is predicated purely on a supportive macroeconomic environment or a favourable political outcome. In fact, our default assumptions around new investments usually factor in an adverse environment. Should the reality turn out to be better than expected that is an added benefit, but it is never a standalone reason for investing.

A good example is our holding Capitec Bank, a leading private sector bank in South Africa which has been able to buck the country's challenging economic trends. It has done so through a combination of strong execution by its management team, a customer-first mindset with consistent innovation and scale benefits, and a favourable market structure with large incumbents who have been slow to react for fear of disrupting their own profit pools. Over the past 15 years, South Africa has witnessed tremendous upheaval, including serious mismanagement of various key institutions and regulatory capture driven by endemic corruption. Like in many developing nations, such tumult has manifested in periodic currency devaluations; and indeed the South African rand has lost around 57% of its value against the US dollar over the past 15 years. Despite these headwinds, Capitec has managed to compound its book value per share (BVPS) in USD by 18.7% and shareholder returns in USD by an astonishing 24% CAGR[1] over the same period (which compares to the 0.7% CAGR in total returns for the MSCI Emerging Markets index).

The broader point to make is that despite even the worst macroeconomic backdrop, great management teams usually find ways to deliver outstanding returns to long-term-minded shareholders. In the following sections we will discuss some of these opportunities as well as two new investments we have made in the previous quarter.

China

Any top-down discussion about China is often based on what is essentially akin to reading tea leaves. With the inner workings of the higher echelons of government remaining deeply inscrutable to most observers, it is only through their apparent actions that we can infer the intended direction of travel. While some would argue the country is sliding backwards into a classic authoritarian trap (preventing it from course-correcting policy mistakes), we would note that China is not the monolithic edifice it is made out to be. It is a diverse nation, both in its polity and in terms of the immense regional differences. Ultimately, this should serve as a safeguard against the country becoming like Russia, where the gradual hollowing out of institutions and bureaucracy has left only the oligarchy and poor governance prospects for minority shareholders.

[1] Compound annual growth rate

As it happens, South China has some of the most entrepreneurial private sector companies in the world, and we do not expect them to be sacrificed at the altar of ideology. In this context, it is worth highlighting our most recent Chinese investment, Sichuan Swellfun. The company operates in the Chinese local spirits industry (known as "baijiu") and is 63%-owned by Diageo, the UK-headquartered leader in the global spirits industry. We have looked at the baijiu industry in detail over the past several years, including its largest companies — Kweichow Moutai (USD 332bn market cap) and Wuliangye (USD 91bn) — in our research efforts. However, whilst we have been struck by the massive profit pool these companies generate, we have been uncomfortable with their governance standards. Our concern is around the use of high-end liquor as a means of "gifting" (a.k.a. bribery) for government officials and the huge amount of trade margins commanded by the channel distributors.

However, at Swellfun we believe these concerns are mitigated by multi-national corporation (MNC) standards of governance and a demonstrated intent to keep channel inventory as low as possible. Diageo has been wrangling for control of the company since 2009, only managing to secure its controlling stake in 2018. Like in the case of Diageo's acquisition of Indian-based United Spirits from maverick entrepreneur Vijay Mallya in 2012, there has been a period of painful restructuring at Swellfun since then. The company has only a 0.6% market share of the overall baijiu industry, but its share of the mid-to-premium segment is more substantial and where consumer preferences are shifting toward. As a result, Swellfun's volume growth has been strong at 15% CAGR over the past five years, in an industry that has otherwise witnessed consistent decline. With return on capital employed (ROCE) in excess of 100% and healthy cash generation, we are confident that the combination of Diageo's experience in global spirits and Swellfun's local brands will result in strong growth for the company over the next decade. Our recent conversations with the senior management also provided us with some comfort that minority investors are aligned with the parent. Valuations, which for a while had been excessive, have become attractive (6% free cash flow (FCF) yield) as the stock price corrected materially over the past year or so. We will look to build more conviction over time.

Brazil

If we were to pick one country among the major emerging markets as the poster child of macroeconomic and political volatility, it would probably be Brazil. The mood here tends to swing often and wildly, from unbridled optimism to gloomy despair — just consider the past couple of decades or so. From 2003-10, with President Luiz Inácio Lula da Silva at the helm, Brazil was hailed as another economic miracle (after China). With an unprecedented bull run in its key commodity exports (driven mostly by China's soaring demand), the government funded widespread social schemes such as the Bolsa Família initiative, which paid low-income families USD 35 per month if they met certain conditions (e.g. keeping their kids in school). A wide gamut of social indicators showed massive improvement during his term — for example, poverty fell from 40% to 25% and infant mortality rates plummeted. These schemes, in addition to an aggressive increase in minimum wages, allowed the Brazilian middle class to expand; and demand for cars, air conditioners and other first-time purchases exploded. However, from there it has been quite the fall.

Today, after more than a decade of economic turmoil and political instability, the average Brazilian is now about 20% poorer than he or she was during Lula's final year in office in 2010. The recent mishandling of the Covid crisis by incumbent President Jair Bolsonaro (Brazil's far right "Trump of the Tropics") has left the country under severe stress. Whether we look at incomes, health indicators or even the fate of the Amazon rainforest, Brazil's decline seems clear. This makes the upcoming election in October a critical one.

For one, Lula, who went from being "the most popular politician on Earth", as per former US President Obama, to being imprisoned for an embarrassing money laundering scandal, is back in the fray for the top job (by popular demand it would seem, going by several opinion polls). However, we have seen this movie before, so to speak. It is a classic of Latin American politics: an ageing leader who presided over a commodity-driven economic boom is voted back into power, in the hope that he or she can "bring back the magic". Juan Perón in Argentina, Carlos Andrés Pérez in Venezuela and Colombia's Álvaro Uribe, have all either returned to power themselves or helped their protégés get elected. These comebacks have mostly ended badly, as the realisation dawns that macroeconomic cycles are beyond the control of any one individual. We will be watching the situation in Brazil carefully over the coming years.

Despite all of this, we are not waiting around for the perfect moment to invest in Brazilian companies. Like in other tough operating environments, there are still businesses in Brazil that have enviable track records of compounding capital. There are Brazilian companies on our watch-list where we have carried out substantial analysis and know the management teams and franchises well. Valuations in recent years meant that investors were not being compensated for the relatively higher risks the country faces — and we have been disciplined in this regard, having negligible exposure. However, with the recent sell-off, some companies have begun to offer an acceptable level of potential upside. In this context, we recently purchased a small position in a company we have been following for a while: TOTVS, a leading Brazilian software company.

TOTVS was founded in 1983 by Laercio Cosentino and Ernesto Haberkorn. Today, TOTVS is the dominant enterprise resource planning (ERP) software provider in Brazil with nearly 50% market share. Its core product serves over 40,000 small-to-medium sized enterprises (SMEs), which global software companies like SAP and Oracle often can't and don't serve well. TOTVS' products have been localised for Brazilian customers with respect to language, tax rules, accounting policies etc. It has a strong on-the-ground presence via its own branches and exclusive franchisees, which helps to service customers effectively. Distribution is an important advantage. All of this, in our view, adds up to a wide moat in the form of switching costs. This is reflected in a 98% client retention rate for the company each year.

As is true for our other portfolio holdings, we have met TOTVS many times over the years, and like the combination of family ownership and professional management. Laercio's and Ernesto's families own 15% of the company and act as long-term stewards. The company has professional management in the form of Dennis Herszkowicz (the CEO) who brings in the necessary experience and capabilities to grow the business. TOTVS' operating performance has improved significantly, after experiencing a period of stagnation in the middle part of the last decade. In addition to the company's rejuvenation, the transition from a traditional licence-based model to subscription-based revenue is well underway under the leadership of the CEO. Subscriptions account for a third of revenue today and over half of incremental revenue. Subscriptions lead to higher revenues and higher customer lifetime values, and should contribute to more half than of TOTVS' revenue in 2-3 years' time. Early success in adjacencies is another driver of medium-to-long term growth and we remain optimistic about TOTVS' prospects.

The biggest challenge is perhaps its valuation. Quality — by which we mean good owners and management, a strong franchise, reasonable growth and a net cash balance sheet — doesn't come cheap. TOTVS is currently valued at 3% FCF yield with high growth expectations. This leaves very little margin of safety if we are wrong about the prospects of the investment case, and is why our initial positioning in TOTVS remains small for now. We will wait for Mr Market to present us with a more attractive opportunity to own more of this wonderful company.

India

The past decade has been challenging for India, with Gross Domestic Product (GDP) growing at a sub-par 5.7% compounded annually (in US dollar terms, 2011-21) versus 14% CAGR witnessed over the decade prior (2001-11). The country has navigated a series of events that have dampened domestic demand. For example, prior to Prime Minister Modi's Bharatiya Janata Party (BJP) sweeping into power in 2014, there had been several headline-grabbing corruption scandals which resulted in a freeze on credit disbursements and an overhaul of the natural resource allocation process. Then, in 2016, the government announced a demonetisation program, ostensibly aimed at tackling money laundering and counterfeiting. Just as the economy was recovering from this shock, the government implemented wide-ranging tax reform (the Goods and Services Tax — or GST) in 2017, which simplified India's byzantine tax system. Whilst this long-awaited reform is undoubtedly positive over the long term (in fact, only now are we witnessing positive results from the reform), the medium-term impact of this change at the aggregate level was negative, as informal businesses found it hard to operate and ceded market share to larger, more established firms. In 2018, a couple of large Non-Bank Finance Companies (NBFCs) faced a solvency crisis owing to mismanagement, sparking off a credit liquidity squeeze in the entire financial system. By the time all these issues were repaired in 2019, the world went headlong into Covid-induced lockdowns. As a result, despite a range of supportive reforms across sectors (in real estate, labour and agriculture, for example), the economy has been lacklustre. It is only now that we are seeing demand stabilise and managers thinking about adding capacity again.

Despite this bleak backdrop, you wouldn't know it if you spoke with the managers of our Indian company holdings. For example, United Breweries, which is Heineken's India-listed subsidiary, has managed to compound its earnings per share (EPS) at a respectable 14% CAGR over FY2012-22[2] and Syngene has witnessed sales grow by 20% CAGR. HDFC Bank has grown its loan book at 21.7% CAGR and its BVPS at 20% CAGR. These businesses are beneficiaries of multi-decade tailwinds that have helped them grow despite challenges in the broader economy. Imagine what they might do if the economy itself starts growing as fast as it is capable of?

Positioning and outlook

While the emerging markets asset class may be going through a challenging period at the moment, one of the key attributes in our search for quality companies is sustainable business models that are attractive not only from a one to two year perspective, but throughout the business cycle. We continue to invest in quality businesses that have proven management teams and competitive advantages that allows them to capitalise on the long-term secular trends that continues to exist across emerging markets. Whether it is the formalisation of the Indian economy, the continued financialisation of the South African population or the growing ERP adoption by Brazilian SMEs, we believe the investment opportunities are plenty. Yet, these kinds of businesses are often not well represented in broader

[2] Companies in India report on a fiscal year basis from 1st April to 31st March

indices and therefore we believe a bottom-up active investment approach has much value to add. Our own portfolio of 40 businesses is a good example. We believe our holdings offer attractive compounding opportunities over the long term and our analysis suggests they can grow earnings at 13-15% CAGR on a weighted average basis over the medium term. For this kind of growth, the portfolio's aggregate valuations, at around 5% FCF yield and a PER of around 20x prospective earnings, seem reasonable (and sustainable) to us and should bode well for longer term returns.

In this letter, we have tried to cover points which we think might be of interest to the strategy's investors. If there are any questions or feedback concerning the strategy, our approach or operations, we would welcome hearing from you.

Thank you for your support.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 30 September 2022 or otherwise noted.

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