FSSA Investment Managers

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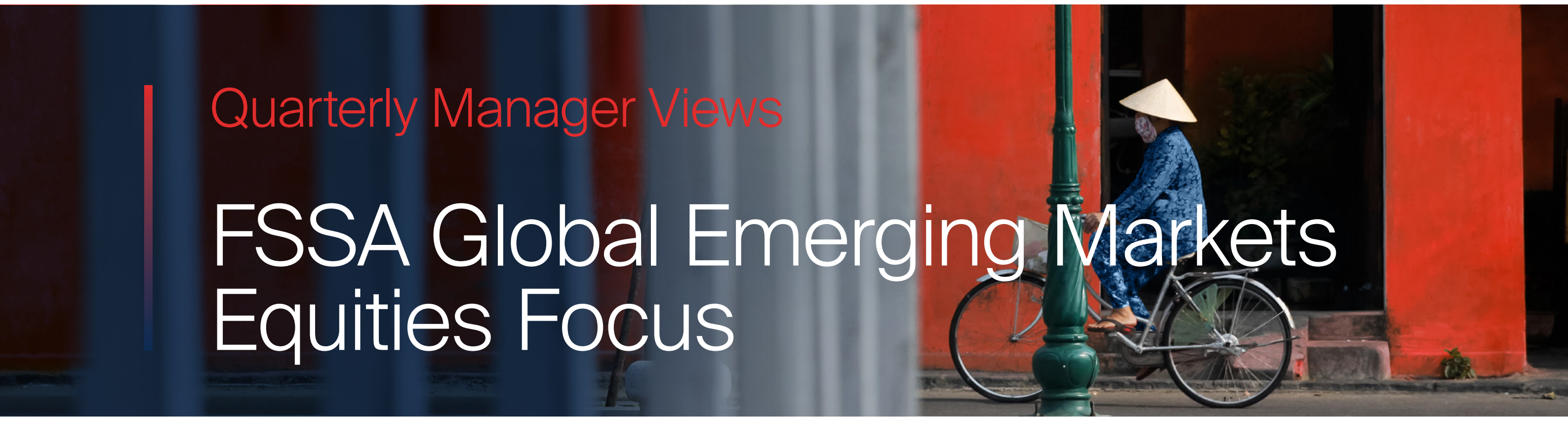

Quarterly Manager Views

FSSA Global Emerging Markets Equities Focus

At FSSA Investment Managers, we believe that meeting management teams is crucial in assessing the quality of a company. Although we remain sceptical and critical of most that we encounter, we also recognise that having the right management team is absolutely critical for execution, alignment and long-term success. While some investors may claim that management meetings are a waste of time because of the limited impact an individual can have on a business, we find it amusing when those same people assert, paradoxically, that they as individuals can make a real difference to their client's investment return!

Our emphasis on management teams does not mean that we are prepared to compromise on business quality or valuation to back a "rockstar" manager – after all, if the problem is the horse, even champion jockeys will not win the race. Yet in our experience, it is rare for a company to perform well over a sustained period of time without an exceptional management team at the helm.

When evaluating management teams, we focus on three key areas: operational excellence, capital allocation and culture. By operational excellence, we mean the strategic decisions a management team undertakes to enhance the intrinsic value (or business value) of the company. While this would typically manifest in areas such as market share, sales growth, margins and capital efficiency, etc., it also needs to be viewed in the context of the initial hand the management team were dealt when they took over, as well as overall industry trends, regulations and so on.

One of the best examples of operational excellence we have come across in our portfolios is at Taiwan Semiconductor Manufacturing (TSMC) under Morris Chang, its founder and former CEO. Since inception of the company in 1987, Mr Chang has instilled a relentless focus on innovation and cost management while pioneering a price-leadership strategy that meant that TSMC slowly but steadily outcompeted its peers. This can be seen in the company's return on invested capital (ROIC) trend, which rose from 12% in 1992 to 32% in 2018 when he stood down as chairman. Similarly, the company's share of the industry profit pool increased from 50% in 2000 to nearly 100% in 2019!

Another portfolio holding with more recent evidence of strong operational excellence is Yum China, the largest Quick Service Restaurant (QSR) chain in China. Since becoming group CEO in 2018, Joey Wat has created a more performance-driven culture with a strong focus on innovation, leading to improved payback periods at the store level, a transformation in its menus, and upgraded delivery and membership systems. Today the company boasts 1.25x higher margins compared to before Ms Wat took over the helm, a membership base of more than 400m customers, non-dine-in contribution at over 70% of sales and a network of almost 13,000 stores – features that are unrivaled in the industry especially at a time when operating metrics have largely gone the other way for most of its peers. The point we'd make here is that superior management execution can not only help companies capitalise on opportunities but also on mitigating risks.

Another aspect we look at when assessing management teams is capital allocation. In particular, we want to understand how the team prioritises between reinvestment opportunities, mergers and acquisitions, and returning capital to shareholders. This is a slightly more difficult skill-set to evaluate because it ultimately involves making judgement calls, the success of which in many cases will only be clear in hindsight. This is why we spend much of our time in meetings trying to understand the management's capital allocation framework, priorities and concerns, and to challenge them on their thinking where necessary.

A good example of great capital allocation is at our holding Grupo Aeroportuario del Sureste (ASUR), an airport operator in Mexico. We have in previous letters discussed the attractiveness of airports as an investment with their appealing monopoly characteristics flanked by a high-margin retail operation. However, with the right management team in place, those returns can be even more attractive. Compare ASUR's results over the past 15 years with Grupo Aeroportuario Centro Norte (OMAB), a competing operator in Mexico. OMAB's earnings before interest, taxation, depreciation and amortisation (EBITDA) has grown by six times while its share price has risen five-fold. Meanwhile, ASUR has delivered almost twice that result with EBITDA growing 11 times over and its share price rising eight-fold. We believe this can be attributed to ASUR's CEO, Adolfo Castro, and his long-serving team's approach to deploying capital.

There are two simple rules to ASUR's capital allocation: 1) it only invests in value-accretive acquisitions that meets its strict stress-testing framework; and 2) to otherwise return excess capital to shareholders. This discipline minimises the potential for value destruction and means that while acquisitions are carried out only infrequently, when they do occur the results can be outstanding. For example, when we reviewed ASUR's last acquisition in Puerto Rico and Colombia, we estimated a cash yield of 22% on its investment in 2019 alone. In other words, the company should recoup its investment within a period of five years, an impressive rate of return by any measure.

Finally, we focus on a company's culture. We believe this is the secret ingredient that makes organisations truly great. Because it is intangible, investors usually ignore it during investment decision-making. But, in our view, there is no denying that when entering the offices of a company with great culture, one can immediately sense it. It is a bit like being in love — not easy to define or describe, but the individuals concerned just know!

One common aspect we have found across companies with great cultures is that it is always set and nurtured from the top. This makes our job somewhat simpler — if we notice that the culture is poor when we meet the founders or the CEO of a company, our view is unlikely to change when we meet the rest of the management team. Over the years, we have developed a mental checklist of cultural markers. For example, we make it a point to visit the offices of each company we own or are interested in. We pick up a variety of clues in the process — from the parking lot (too many Ferraris?!) to exclusive elevators (for directors only), and in the flashiness of the office (or lack thereof) to pictures of senior management with politicians adorning the walls (red flag!) and so on and on.

In our meetings, we observe the dynamics between the founder and the senior team, or between the CEO and the CFO/investor relations team, to assess whether the culture is open for constructive debate. A check on family members in executive roles tells us how far the organisation has progressed with regards to building a meritocratic and professional culture. The degree of centralisation in decision-making can be an indication of whether the culture is overly proscriptive. Pro-cyclical cultures can be identified when managers announce grand targets and make aggressive investments when the going has been particularly good in an inherently cyclical industry (such as banking, for the most part). Other markers of culture that we look for include attrition ratios, promotions only from within, and the distribution of employee share ownership schemes across a wide or narrow employee base. All of this helps us to assess the culture; but we would readily admit that it remains something of an art that one only learns from experience.

Management teams exhibiting great cultures are rare, but we believe they are worth making the effort to find. The results they produce can far exceed that of their peers, especially in cyclical industries where being conservative at the right times can pay off handsomely in the future. We were reminded of this during a recent trip to Jakarta, Indonesia as we sat down with two of the leading banks in the country, the private-sector bank, Bank Central Asia (BCA), and the public-sector bank, Bank Mandiri.

As a government-owned bank, Mandiri enjoys a relatively close relationship with other government entities, allowing it to grow its share of loans and deposits rather easily in a segment where defaults are low. However, the leadership team typically changes every 3-5 years as the government rotates the top executives among its various financial bodies. As such, we often observe instances where a newly installed management team are keen to leave their mark, charting a new strategy to grow in areas previously unexplored only to get burnt when the credit cycle turns negative. A fresh new management team is then installed to unwind the previous strategy and clean up the books, and no sooner is this done than another new team is installed yet again to carry forward more ambitious plans for the bank.

This is in stark contrast to BCA where the Hartono family have been the largest shareholders since the Asian Financial Crisis. Under their ownership, BCA has been run by a steady team of professional managers who have consistently demonstrated a strong sense of risk-awareness and an understanding of where they need to invest for the long term. This has helped BCA build a formidable low-cost deposit franchise which in turn enables the bank to lend in a selective and counter-cyclical manner.

The results are evident in the numbers. While both banks have grown their assets and deposits at a similar 12-13% compound annual growth rate (CAGR) over the last 15 years, BCA's growth has been higher quality with its book value per share compounding at 17% annually compared to Mandiri's 14%. This in turn means that while Mandiri's share price has increased by a respectable eight-fold over this period, BCA's share price has risen by almost fourteen-fold, or 50% higher than Mandiri. In our opinion, the main reason for the divergent performance can be attributed to the differences in culture.

Changes to the portfolio

Last month some of us travelled to China for the first time in over three years to meet companies face to face. We visited Shenzhen, which we regard as one of the most liveable cities in China's Greater Bay area thanks to its early economic development and the numerous large businesses that call it home (Tencent, Midea, Foshan Haitian and Shenzhen Mindray, to name just a few). We were surprised to see how quickly the city has normalised. Restaurants were completely full, queues at coffee shops were long and the streets were jammed once more. We also learned that the big technology companies (Tencent, Alibaba and ByteDance) were actively hiring again. We are cautiously optimistic that the economy may normalise much faster than people expect. From that perspective, it is hard to square the overseas media's negative headlines on life in China with what we observed during our visit.

One of the companies we met on the trip is also the latest addition to the portfolio — Shenzhen Mindray, the leading medical device manufacturer in China. As a team, we have followed the company for more than 10 years and have been impressed by the operational capabilities and strategic focus of the founders and senior management team. The company was founded in Shenzhen in 1991 and has demonstrated a strong track record of new product innovation, mergers and acquisitions, and expansion into new geographies. For example, the company counts all of the top 20 hospitals in the US, as well as other established medical institutions in Europe, as its clients. Mindray has also successfully grown beyond its first product line of patient monitoring systems into more technically-advanced areas such as medical imaging and in vitro diagnostics. Since 2005 the company has delivered revenue and net profit growth of 22% and 28% CAGR respectively while ROIC averaged over 100% for the past five years.

Key to these results is their core competency in research and development (R&D). This can be traced back to when the founders worked together in the 1980s at one of China's first medical device companies. This entity was responsible for creating many of the nation's first locally-made devices including magnetic resonance imaging (MRI) scanners and surgical systems (one of Mindray's co-founders actually invented China's first colour ultrasound machine). Subsequently, the founders' reputation helped attract R&D talent to Mindray after it was established, which led to the company's first breakthrough in the patient life and monitoring segment. As sales grew, Mindray maintained R&D spending at 9-10% of revenue, creating a self-perpetuating cycle of new product launches, higher sales, a greater ability to attract talent and continual investment into R&D — which then further supported new products and sales growth. With projected revenue amounting to USD 5bn in 2022, its R&D spend of USD 500m dwarfs that of any other medical device company in China.

Mindray has also developed a comprehensive distribution network which competitors cannot easily match. The company was among the first to cultivate its own distributor channel in the 1990s and today its products are used in 110,000 medical institutions and almost all of the Grade-A tertiary hospitals in China. We believe this distribution advantage will only become stronger as Mindray expands its product lines, creating a one-stop-shop proposition that unlocks additional selling synergies while increasing its stickiness with hospitals.

In addition, the company has established a strong cost advantage over its competitors. As one of the industry first-movers, Mindray enjoyed early scale advantages which it has reinvested into automation and tailor-made manufacturing solutions ahead of peers. As a result, the company is able to offer products with similar features as overseas players, but priced 25-30% lower. This compelling value proposition has helped Mindray expand its global network of customers with sales to 190 countries. This in itself creates additional R&D synergies as the company learns more about the sophisticated needs of overseas hospitals and develops better products to sell.

Perhaps the most important elements driving Mindray's success are its people and culture. As mentioned earlier in this letter, culture comes from the top; and in Mindray's case this comes from the co-founder and chairman, Li Xiting. As the largest shareholder in the company with a 27% stake, Mr Li acts as a strong steward and voice of caution within the team. Unlike other founders in his position, with such a concentrated position of personal wealth held in the company, he has neither sold nor pledged any of his shares. In addition, Mr Li places a strong emphasis on cash generation, and has rejected the distributors' appeal to make purchases on credit. With his risk-aware approach, it is no surprise that the company has been able to grow and execute well.

While Mindray's valuation is not cheap on a 3% free cash flow (FCF) yield basis, we believe it will be a significantly bigger company 10 years hence. Firstly, the previously mentioned scale advantages in its R&D and cost structure should continue to position Mindray for continued market share gains, both domestically and internationally. In China for instance, Mindray only commands a combined 15% market share (based on the categories where they are present) while brand leaders in other markets typically command a dominant share of 60-70%. This points to continued room for market share gains across most of its categories. Secondly, China's medical device penetration is estimated to be 50% of developed markets, while the rest of emerging markets ex-China is estimated to be just 50% again of China's level. As we expect penetration rates of medical devices to continue to rise in the coming decades, this should bode well for growth in Mindray's existing product lines as well as its expansion into new, adjacent areas. As the board secretary said to us in Shenzhen: "The good days are yet to come," and we look forward to holding this company long into the future.

Outlook

2022 was a volatile year with several popular "pandemic winners" starting to discount a more realistic outlook. Equally, franchises with good long-term prospects that had been affected by temporary uncertainties (caused by the pandemic) have for the most part regained lost ground as their underlying business fundamentals improved.

We continue to invest in businesses that we believe have proven management teams and competitive advantages that allow them to capitalise on the long-term secular trends that exist across emerging markets. Whether it is the formalisation of the Indian economy, the continued financialisation of the South African population or the growing adoption of enterprise resource software by small and medium-sized Brazilian companies, we believe the investment opportunities are plenty. Yet, these kinds of businesses are often not well represented in broader indices and thus we believe a bottom-up active investment approach has much value to add.

Looking ahead into 2023, we believe our holdings continue to offer long-term attractive compounding opportunities and our analysis suggests they can grow earnings at a mid-teens rate 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 23x price-to-earnings ratio (PER) seem reasonable (and sustainable) to us. This makes us optimistic from both an absolute and relative perspective.

In this letter, we have tried to cover points which we thought 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 28 February 2023 or otherwise noted.