

TRANSCRIPT: EPISODE 241

23 February 2023 (pre-recorded 9 February 2023)

Below is a transcript of the episode, modified for your reading pleasure. Please check the corresponding audio before quoting in print, as it may contain small errors. Please remember we've been discussing individual companies to bring investing to life for you. It's not a recommendation to buy or sell. The fund may or may not still hold these companies at your time of listening. For more information on the people and ideas in the episode, see the links at the bottom of the post.

[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. This week we cover global emerging markets. We review past performance, discuss the outlook for the sector and discover which companies are bucking the trend in the region. Having recently visited China, our guest also gives us his opinion on the changes occurring in the country.

Joss Murphy (JM): Hi, I'm Joss Murphy. Today I've been joined by Rasmus Nemmoe, manager of the FSSA GEM [Global Emerging Markets] Focus fund. Hi, Rasmus, how are you?

Rasmus Nemmoe (RM): I'm very well, thank you.

[INTERVIEW]

JM: Well, let's kick things off then Rasmus - emerging markets have disappointed in the past decade. Why has this been the case?

RN: Well, first of all, thank you very much for inviting me today. On the question, I would say, emerging markets is a very broad and diverse asset class. There are actually many companies which have done well over the past decade, but if you look at the index itself, it is to a large extent still dominated by many Chinese SOBs [*State Owned Banks*], Korean Chaebols [*a large industrial South Korean conglomerate run and controlled by an individual or family*], Latin American commodity exporters, which have not been great long-term investments.

We have always believed that the best way to generate attractive returns in emerging markets is to sidestep the default exposure one gets from the index and really look beyond that. Some of the areas that we are particularly excited about are, for instance, companies with exposure to the formalisation of the Indian economy or the continued financialisation of the South African population, or the growing ERP [*Enterprise Resource Planning*] adoption by Brazilian SMEs [*small and medium enterprises*]. The investment opportunities are plenty, yet these kinds of businesses are not well represented in the broader indices, and thus we believe a bottom-up, active investment approach has much value to add.

TRANSCRIPT: EPISODE 241

JM: With a different economic environment now sweeping the world, do you think the outlook for emerging markets is brighter?

RN: So, while we do believe that the outlook is improving for global emerging markets, we have never believed that investment decisions should be predicated purely on a supportive macroeconomic environment. In fact, our default assumption when making new investments, always factor in an adverse environment, and should the reality turn out to be better than expected, that's just an added benefit, but it's never a standalone reason for investing.

A good example is our holding Capitec Bank [Holdings Ltd], a leading private sector bank in South Africa. It has been able to buck the country's challenging economic trends. It has done so through a combination of a strong execution by its management team, a 'customer first' mindset with consistent innovation and scaled benefits, and favourable market structure with large incumbents who have been slow to react for fear of disrupting their own profit pool. Over the past 15 years, South Africa has witnessed tremendous upheaval, and like in many developing nations, such tumult has manifested itself in periodic devaluations. Over the past 15 years, the South African Rand has lost nearly 60% of its value against the [US] dollar. Despite these headwinds, Capitec has managed to compound to book value per share close to 20% and share all the returns close to 25% annualised over the same period. This compares to only 1% 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. Capitec and other businesses we like, 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's capable of!

JM: All very interesting points, Rasmus. Asia tends to dominate emerging markets and we hear quite a lot about it, but what about Latin America and Africa? Are these areas becoming more investible? Do you find opportunities there?

RN: Yeah, in my opinion, they have never been uninvestible, but you don't have the same opportunity set as in Asia, simply because the universe is smaller. There are fewer quality companies to choose from compared to say India and China. Still, there are some great investment opportunities.

One of our largest holdings is called Alsea [Alsea, S.A.B. de C.V.], which is a Mexican Starbucks operator. It also operates other brands such as Dominos and Burger King. The starting point is that the restaurant industry is generally a tough industry; while entry barriers are low, so are survival rates. Given the fragmented nature of the industry, consumer mind share is critical. From that perspective, the association with some of the world's strongest brands should not be underestimated. The brand does not only drive customer traffic, but it also gives pricing power on a sustained basis. As a result, Alsea

TRANSCRIPT: EPISODE 241

commands some of the highest operating margins in the industry, which is helpful for returns over the cycle.

Strongly negative working capital is another welcome feature of Alsea's dominant branding position, which is a source of funding that competitors do not have access to. Alsea has already invested significantly in distribution and operating centres, which means that asset turns should improve gradually in [the] coming years. The outcome of all these variables is that we see return on invested capital expanded to attractive levels in the coming years as the market is still vastly underpenetrated. For instance, Mexico only has five Starbucks outlets per million people as opposed to 43 in the US and 15 in the UK. We believe there's plenty of growth left in the sector to ensure solid cashflow expansions in years to come.

JM: Rasmus, your fund launched five years ago and quite a lot has happened in emerging markets in that time, even more than usual. We've had geopolitical tensions, panic over the election of leftist governments in Latin America, and Covid to mention a few things. How do you invest through these types of things? And since it launched, the fund has returned 26% while the average peer's returned just 6%. I would say that's pretty impressive.

RM: <Laugh>. Well, thank you.

JM: How have you managed to outperform?

RM: The portfolio is long-term oriented, seeking to invest in businesses that have structural competitive advantages, attractive reinvestment potential and stewarded by great management teams. As a team, we are primarily long-term bottom-up investors and work with an absolute return mindset when selecting stocks. We have a high preference for quality companies with sustainable and predictable growth, which we then combine with a strong valuation discipline. Historically, we have focused on growing our clients' wealth by protecting capital in down markets, and not chasing strong liquidity rallies that we see from time to time. That's how we have done over the long-term.

Having said that, from a more recent perspective, I think it's fair to say that we were quite wrong-footed in the early stages of the pandemic, which challenged how we usually behave in down markets. The unprecedented lockdowns had a huge impact on many of our holdings given our focus on service companies in best developed countries.

For instance, Alsea - we discussed earlier - had never experienced same store sales decline of more than 4% prior to the pandemic, but yet during the second quarter of 2020, they saw sales declining 60 to 70%.

And equally for some of our travel related companies like airports, the decline was even greater at 95%.

TRANSCRIPT: EPISODE 241

However, after the lockdown secured, we took a step back and did a deep dive on all our holdings. We had calls with management teams and reevaluated the businesses. Fortunately, this gave us great confidence in the longer-term trajectory of our holdings. The majority of our holdings are market leaders, and what we realised was that if they were struggling, competitors would be even worse off.

By talking to management teams, it became increasingly clear that coming out of the crisis, many of our holdings would have even greater market share and face less competition. And not only that, because they were cutting costs like there was no tomorrow by, for instance, renegotiating rental agreements, supply contracts, [and] focusing on efficiency, the operational leverage should also result in margin expansion that in many cases would outstrip their pre-pandemic heights. So, even though we had a challenging period in the early stages of the pandemic, we tried to take advantage of the situation and found some very attractive bargains, especially among Indian private sector banks and Latin American consumer companies, which eventually worked out ok.

JM: Last time we met with your team, they mentioned six buckets of investments including digital consumer platforms, dominant quick service restaurants, high-quality insurers and legal monopolies. Can you tell us a bit more about this please?

RN: Yeah, the portfolio is the receptacle of where we find the best long-term investments. We specifically focus on strong management teams in quality franchises, with defensive characteristics such as high return and recurring cash flows. While we are not thematic investors, I would say that emerging markets have some very strong circular tailwinds like demographics, urbanisation trends and productivity gains that facilitate strong demand for barriers, goods and services.

We focus on companies that will benefit from selling all the things we know that the growing middle class in emerging markets will consume more of in the next five to ten years. One example would be premium consumer products like beer, spirits, make-up, cars, clothing, food, you name it. Like everywhere else, emerging market consumers want to upgrade and premiumise when they get the chance. And from a company perspective, if you have the right business model with a competitive advantage that allows you to capitalise on that opportunity, you're typically in a very good spot.

We also like companies that benefit from increased financialisation of emerging markets. As consumers become more affluent, they also become more attractive for banks to lend to. And we see demand for credit rising in line with GDP expansions. But it's not just credit, it's also other financial services such as insurance and increasingly investments such as asset management.

And finally, the ongoing digitalisation we see in emerging markets - the move from offline to online - has created some fantastic business models, typically with more attractive margin profiles and less asset intensity compared to offline competitors. This makes them ideal candidates to not only benefit from rising consumption penetration, but also from the market share they can take from offline legacy brick and mortar businesses. But going back to your first questions around the biases in the portfolio: the

TRANSCRIPT: EPISODE 241

simple reason is that consumer companies, financials,[and] digital platforms, have done very well over the years and we believe they will continue to do very well in the future.

JM: Makes sense. Do you have any examples of these buckets throughout the portfolio?

RN: Yeah, our largest holding is HDFC Bank in India. HDFC Bank is arguably India's best bank, if not one of the world's best banks. Over the past 20 years, the book value per share has compounded at a 23% annual growth rate, resulting in total shareholder return of 20% annualised in US dollar terms over the same period. The 20-year average return on asset is 1.7% and the lowest it tested to is 1.4%. And this is despite of what India has witnessed over the past two decades, which include one pandemic, two banking crises, three substantial stock market crashes, four severe droughts, and five prime ministers! Other Indian banks have grown impressively in size too, but HDFC Bank stands out for the lack of any major misstep, despite everything that India has thrown in it. And that's a quite a rare quality.

Another large holding of ours would be JD.com. JD is China's second largest e-commerce company and operates both direct sales and a marketplace platform and has built its own nationwide fulfillment infrastructure. The company is dominant in the electronics and white goods categories and in recent years, it has also built a significant presence in fast moving consumer goods as well as other general merchandise categories. Consumer electronics is a standardised category with high inventory turnover, making it ideal for cost-optimised business models such as online selling. As JD achieved increasing gains in procurement scale, it passed these scale benefits onto customers in the form of lower prices, which again attracted more customers and the foundation for its scale-based competitive advantage flywheel was created. In our opinion, JD is in a much better position than the majority of its peers given its scale and substantially more efficient operations. In our view, JD should be able to raise margins in the coming years to a level where it will remain the cost leader, whereby [it will] at the same time also make healthy profit margins. That is a common trait for the world's best retailers. And the key reason why we like JD.

JM: Rasmus, the portfolio holds a number of positions in China. Can you please provide an update on how these stocks are faring? I know we recently spoke - before we started - that you were there. Can you tell us a bit more about these positions please?

RN: Yeah, well, while China is currently going through challenging times, we feel confident in our holdings' ability to navigate the situation, as they have done in the past. Competitive advantages in the form of strong brands, distribution advantages, cost leadership, or simply providing a service product that customers cannot live without are the main traits that characterises our companies.

While the market has recovered, somewhat, many companies are still below their long-term averages and more importantly trading [at] what we believe is below their intrinsic value. That is why when the market corrected last year, we saw that as an excellent opportunity for long-term investors like us, to accumulate leading franchises at attractive prices. On that note, I was actually in China last week for the first time in three years. It was a very interesting trip and it was great to be back. I flew in from Hong Kong and

TRANSCRIPT: EPISODE 241

surprisingly China felt much less restricted compared to Hong Kong. Mask mandates are not really enforced any longer and from our conversations, I got the sense that the Chinese are so much over Covid, they just want to go get their normal life back. It's also very clear that there's going to be a lot of pent-up demand; savings rates are high as consumers couldn't spend during the lockdowns and it's very clear that this was already happening. Restaurants were full, the usual traffic jams started again. and shopping malls were packed. It really felt like things were normalising. Another interesting observation was also that all the big tech firms are now starting to hire again - that I think is quite indicative of what is to come.

JM: Rasmus, thank you very much for your time today.

RN: Thank you very much for having me, I appreciate it.

SW: FSSA Global Emerging Markets Focus fund invests in 40-45 large and medium-sized companies across emerging markets. Each holding is a quality company that can show sustained and predictable growth over the long term. The fund has a strong environmental, social and governance ethos without labelling itself as such. To learn more about the FSSA Global Emerging Markets fund visit FundCalibre.com – and don't forget to subscribe to the 'Investing on the go' podcast, available wherever you get your podcasts.

Please remember, we've been discussing individual companies to bring investing to life for you. It's not a recommendation to buy or sell. The fund may or may not still hold these companies at the time of listening, Elite Ratings are based on FundCalibre's research methodology and are the opinion of FundCalibre's research team only.