July 2023

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Quarterly Manager Views

FSSA Global Emerging Markets Equities Focus

One of the true competitive advantages we believe we have at FSSA is a genuine long-term investment horizon. For us, investing is not about trying to predict which stocks will rise or fall next month or quarter; rather, it is a non-speculative activity aimed at participating in the long-term value creation we believe the best companies can generate.

Our investment philosophy, process and business structure all encourage long-term behaviour, which means that we have the luxury of making decisions without the usual industry pressure of chasing short-term, relative performance. By extending our investment horizon beyond the usual one to two years that most investors would consider the norm of "long term" these days, returns start correlating to a much greater extent with the performance of the underlying business. This makes our job much more akin to that of business analysts rather than share-price chartists.

This is why we emphasise quality in our investment approach — which we define as companies that display solid corporate governance, have attractive growth opportunities with structural competitive advantages and, ideally, benefit from sustainability tailwinds. In our Q1 2023 letter we discussed some of the traits we look for in management teams from an operational, cultural and capital allocation perspective. In this update we will focus on the characteristics we associate with quality businesses.

While finding great management teams is a necessary condition for us to invest, equally important is the quality of the business. Having one without the other can, in our experience, lead to a wide range of less attractive investment outcomes which we try to avoid. Paraphrasing a quote by Warren Buffett, if the problem is the horse, even champion jockeys won't win the race.[1] In our view, the best businesses to own are those that not only generate high returns, but also enjoy a sufficient growth runway to allow the beauty of compounding to work. It is not easy to find businesses that possess both of these qualities (not to mention a management team that we can back); but when we do, we want to buy them at attractive prices and hold on to them for as long as we can.

From a growth perspective, our investment universe of companies located in countries classified as emerging makes this endeavour slightly easier. Emerging countries tend to enjoy natural demand tailwinds in the form of a growing population, rising levels of urbanisation and an increasingly prosperous middle class that facilitates rising demand for various goods and services. While this sounds obvious enough, what people sometimes overlook is also how consumption patterns change as household incomes grow. What was previously considered a treat — for example having a beer, dining out or maybe even flying for the first time — becomes a norm.

As disposable income rises, customers tend to purchase certain products more frequently and try new products or services they have never experienced before. This often leads to an "S-curve" like growth — as income reaches beyond a certain level, purchasing power hits an inflexion point and consumption accelerates, creating a secular trend for years and possibly decades to come. This creates a favourable backdrop for us to capitalise on.

However, not all growth is created equal and while we love growth in free cash flow, other forms of growth do not always equal value creation — especially if it comes with lower margins and elevated capital intensity. Consider for instance products or services where barriers to entry are low and customers have no reason to be loyal. While one might be able to generate volume growth in the short term through price wars and promotions, such customers often jump ship when a more competitive offering comes along. Escalating promotions to win back customers often prelude a race to the bottom and typically does not bode well for investors.

[1] https://www.goodreads.com/quotes/10810209-good-jockeys-will-do-well-on-good-horses-but-no

We are equally careful when growth requires intensive capital and asset investments. Unless the company has an absolute advantage in the industry, the franchise is unlikely to make attractive through-the-cycle returns once we consider the amount of reinvestment needed annually. In certain asset-heavy businesses, it is also common to see “bad behaviour”, where one player expands capacity and commences a price war to increase volume share — industry returns are depressed for months if not years before some normality returns. However, the volume gains are often short-lived as another player will inevitably decide to increase capacity too; and the whole cycle repeats.

For growth to be sustainable we believe it must be supported by entrenched competitive advantages in the form of strong brands, switching costs, network effects or cost leadership — every company should have some combination of these prerequisites to be able to capitalise on its growth long into the future. When assessing a company’s brand, we look at its ability to lower search costs, create positional value, or confer the legitimacy and trust that are critical for a company to secure pricing power and the ability to preserve margins. For companies with offerings that exhibit high switching costs, we look for products or services that are highly critical to their customer’s business processes and are not easily replicated, either because customers have committed significant upfront payments when implementing the products or they offer a high benefit-to-cost ratio to customers.

For companies with network effects, we look at the network’s ability to add value to its customers by subsidising one side of the network or driving continued engagement, which ultimately determines the value of the network over time. Finally, for companies with cost or scale advantages, we look for variants of the “scale economy shared” model where low prices are shared with customers, which in turn attracts more customers and more scale advantages, which again are passed on to customers, thereby creating a strong competitive flywheel advantage that expands over time.

Over the years we have found that there are a few broad industry types where good quality businesses (displaying above-average sales growth with high margins and attractive return profiles) are more frequently found than others. These include (but are not exclusive to):

1. Digital consumer platforms

Over the past 20 years or so, we have witnessed the rise of companies that have connected millions (sometimes billions) of people — be it friends and family (messaging and social media) or customers and suppliers (e-commerce) – resulting in powerful network effects where users are highly engaged. We group these companies under “digital consumer platforms”. Examples include Tencent in China where one billion active users rely on its Weixin app for a range of day-to-day activities (communication, entertainment, browsing); Mercado Libre in Latin America which has over 100 million active users of its e-commerce and digital financial services; and JD.com in China where hundreds of millions of people browse for durable goods with the best e-commerce experience. The high user engagement creates significant opportunities for these companies to monetise the service at low additional cost, resulting in profitable and highly cash-generative businesses which can continue to grow for many years.

2. High-quality private sector banks

Well-run banks in underpenetrated markets can be rewarding long-term investments. However, as growth is often the easy part of operating in markets where access to capital is hard and/or interest rates are high, we find that choosing who NOT to lend to is a more important determinant of a bank’s long-term success. We prefer to own reputable, privately-owned banks with modest market share and strong deposit franchises. Having a low-cost funding advantage is crucial to the long-term investment case of a bank as it enables them to take on less risk than others while generating attractive returns — this in turn allows them to withstand credit cycles better and to increase market share during periods of turmoil. Examples of such franchises include HDFC Bank in India, Bank Central Asia in Indonesia, Capitec in South Africa, and Credicorp in Peru.

3. Great consumer staple brands

With favourable demographics and rising incomes, we believe dominant consumer franchises in emerging markets should offer attractive growth over the long term. These businesses command strong margins and pricing power through various elements of brand, distribution and innovation. Minimal capital intensity and strong cash generation supports the investment for growth as well as the potential for rising dividends. Examples include Tsingtao in China (leading brewery with a 120-year heritage) and Colgate-Palmolive in India (dominant oral care brand that has been operating in the country for over 80 years).

4. Dominant Quick-Service Restaurants

Quick Service Restaurants (QSRs) tend to be cash-generative businesses with attractive unit economics — the best operators can achieve payback on new stores in 3-4 years. On top of this, those that have dominant scale in their sub-segments (e.g. Pizza or Coffee) can enjoy the additional advantages of high consumer brand awareness and economies of scale. Thus, these businesses can attract traffic at lower cost, and maintain gross margins at attractive levels while reinvesting in new initiatives for growth (digital, new formats, new brands), resulting in an excellent model of compounding cash flows over long periods of time. Examples include Alsea in Mexico (operates Starbucks and Dominos in Mexico and other markets) and Yum China (operates more than 13,000 stores of KFC and Pizza Hut brands in China).

5. High-quality insurance companies

In countries that are highly underpenetrated with respect to insurance products and where real interest rates are sustainably positive (and preferably attractive), well-run insurance companies tend to have strong tailwinds. Insurance penetration (e.g. auto, health and life insurance) tends to inflect at certain thresholds of income and grow exponentially for a period afterwards. Property and casualty (P&C) insurance businesses enjoy the "float" provided by customers who pay in advance (and hope not to use the service!) When invested prudently this can continue to compound away for long periods. Life insurance companies are more complicated given the multi-year nature of contracts, but are also beneficiaries of the same tailwinds. Like with banks, the key is to identify risk-aware and counter-cyclical management teams with strong track records. Some examples include ICICI Lombard in India (leading private-sector P&C insurer) and Qualitas in Mexico (leading auto insurer).

6. Legal monopolies

There are certain industries that naturally tend to result in monopolistic or duopolistic market structures. Airports are an example of a local monopoly – once established, it is unlikely that another one is constructed nearby. It is the captive customer base as well as the nature of travel that makes airports an attractive investment – not only is there no alternative for this mode of transport, those who do travel by plane tend to be affluent and typically arrive a few hours earlier to shop and dine, thus generating high-margin rental income for airport operators. Other niches exist too – for example, the back-end of financial services like asset management (secretarial services, know-your-customer (KYC) processes, valuation services, custodianship etc.), where in countries like India, only two players exist. They tend to have durable moats and good return metrics, in addition to a solid customer base. Examples of such legal monopolies that we own in the portfolio include Grupo Asur (Mexican airport operator) and CAMS (Indian back-end services outsourcing player for the asset management industry).

Finally, as part of our quality assessment, we evaluate the risks and opportunities that the company faces from an environmental and social aspect. Management quality and franchise strength should be viewed in a broader stakeholder context and not purely in relation to profit maximisation and shareholder value. How can one adequately assess the quality of the management without a deep understanding of their past treatment of employees? Or view a company's growth prospects without a strong appreciation for its sustainability headwinds/tailwinds?

It is for this reason that we emphasise a common-sense, rather than a box-ticking approach to environmental, social and governance (ESG) matters. To us, the spirit matters more than the letter of the law – a management team that acknowledges its faults and is genuine in its desire to improve standards is preferred over one that produces glossy "Sustainability Reports" but continues to abuse the environment or harm society. Broadly, we try to assess the key environmental and social risks for the entire industry before asking ourselves whether the company in question is doing enough to benefit or lose from these trends. We prefer companies that offer products and services benefiting from customers' increasing awareness of environmental and social impacts as well as management teams that are attuned to these long-term challenges; or at a minimum, are receptive to our engagement where we can perhaps help them on their journey.

Outlook

The last 12 months have been volatile with several popular "pandemic winners" starting to discount a more realistic outlook. Equally, franchises with good long-term prospects affected by temporary uncertainties (caused by the pandemic) have for the most part regained some of the lost ground as their underlying business fundamentals continue to improve.

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 planning (ERP) software by small-to-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.

While China is currently going through challenging times, we are 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 characterise our companies. We believe the current correction in share prices presents an excellent opportunity for long-term investors like us to accumulate leading franchises at attractive prices.

As 2023 progresses, we believe our holdings continue to offer long-term attractive compounding opportunities and our analysis suggests that they can grow earnings at around 20% CAGR[2] on a weighted average basis over the medium term. For this kind of growth, the portfolio's aggregate valuations, at around 5% free cash flow yield or a 22x price-to-earnings ratio (PER) seem reasonable (and sustainable) to us. This makes us optimistic from both an absolute and a relative perspective.

[2] Compound annual growth rate

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 June 2023 or otherwise noted.

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