FSSA Investment Managers

Quarterly Manager Views

FSSA Global Emerging Markets Equities Focus

May 2024

> *"...the species that survives is the one that is able to best adapt and adjust to the changing environment in which it finds itself."*
>
> *Professor Leon C. Megginson (not Charles Darwin)*[1]

At its core, our investment philosophy endeavors to identify quality management teams that run businesses able to compound earnings or free-cash flows at attractive rates for long periods of time. A necessary condition for this strategy to work is that the business needs to maintain its competitive advantage over the investment horizon. Doing so requires constant evolution; and to paraphrase Charles Darwin's work, the most successful businesses are the ones that adapt the best. This is quite obvious when it comes to aspects like a company's unique selling proposition (USP) and how well it is able to defend and build upon its competitive moats. However, the way management teams adapt their businesses, and how they treat all stakeholders (not just shareholders), is often missed by many market participants. And yet, one can learn a great deal about how owners and managers think about important issues by focusing on how they treat other stakeholders. In essence, this is how the environmental, social and governance (ESG) aspects of businesses are analysed by the FSSA investment team. In this quarterly client letter, we aim to discuss our approach in some detail.

What we will not do, ESG-wise

As long-term, quality-focused investors, there are certain industries that we avoid for ethical reasons[2], such as gambling, or the production of tobacco[3] or armaments[4]. We also avoid companies that we believe have governance issues, excessive leverage, overcomplicated ownership structures, or are prone to government interference. Other issues to avoid include the short-sighted pursuit of business gains, reckless corporate conduct, or the exploitation of workers, regulatory loopholes and the environment (we have touched upon this in our previous letters).

We don't believe that everything has a price; and staying disciplined in our process means making decisions which err on the side of caution. There are many cases where we have undertaken a huge amount of research, only to refrain from investing in the end – sometimes, due to concerns about the sustainability of returns or the way certain stakeholders are treated in the pursuit of growth.

Spirit, not the law

We believe that responsible investing requires much more than a box-ticking approach. A significant proportion of our time is dedicated to analysing and interpreting unquantifiable qualities. With this context, we believe that external ESG ratings and data can be useful, but they have their limitations – we use them only as a starting point, if at all.

To begin with, third-party ESG scores rely upon the standardisation and quality of data disclosed by

[1] https://www.darwinproject.ac.uk/people/about-darwin/six-things-darwin-never-said/evolution-misquotation
[2] Our full exclusions policy can be found on our website under Responsible Investment/Exclusion Policy
[3] This includes all companies involved in the production of traditional cigarettes and other tobacco products (including cigars and chewing tobacco), but not including vaping or e-cigarette products, with an effective 0% revenue threshold. This does not extend to minority investments, where a parent company owns less than 50% of a company.
[4] This includes all companies that manufacture controversial weapons and entities that own more than 50% of controversial weapons manufacturers, with an effective 0% revenue threshold. This does not extend to minority investments, where a parent company owns less than 50% of a company.

companies — and this is still lacking, especially in emerging markets. Moreover, while these ratings are frequently interpreted as fact, they are inherently subjective, their methodologies opaque, and in some cases the analysis on which the score is based is just plain wrong.

Nowhere is this more flagrant than the idea of tobacco companies being sustainability champions. For example, Philip Morris International, which makes Marlboro cigarettes, scored 84 points (with 100 being the top score) on S&P's Global ESG Scores — much higher than say, Tesla, which makes electric cars.[5] And British American Tobacco (BAT) scored a whopping 94 points on Refinitiv's ESG rating system — a near-perfect score that indicates "excellent relative ESG performance" and puts it in the category of ESG leader![6]

We would also urge caution around using ESG indices to gauge a company's sustainability credentials, as they are subject to a market capitalisation skew and are biased towards larger but not necessarily better companies. The latter have the budget to produce impressive ESG reports which tick the rating agencies' boxes, but their inclusion and weighting does not necessarily reflect their quality, nor their real-world impact or progression towards sustainability goals. Call us natural sceptics, but we believe the biggest and glossiest sustainability reports often tell us little of real substance (and actually make us more suspicious!) Investors would do well to look beyond a chairperson's letters and ESG labels to ascertain whether their words are indeed embraced in both spirit and action.

Direction of travel, not the current state

The companies we meet and consider for investment don't always "look" good. But as we often say when referring to companies, it is the direction of travel that matters most. When we initiate an engagement, we want to understand how a company is addressing its ESG challenges and opportunities in order to underwrite its long-term success. In this context, our goal is to persuade companies to consider the material issues in their business; and we are supportive of company leaders who are willing to address changing societal and environmental expectations on the way they operate.

What is telling, and the most important part of our engagement, is whether the owners and managers are receptive to our engagement efforts in the first place. We value open and transparent management teams, and our experiences when attempting to engage with management often helps us gain, or lose, conviction in the overall investment case.

For example, we shared with several of our holdings the WWF Sustainable Banking Assessment (SUSBA) 2021 report, which summarises the environmental and social progress (and/or regression) of 36 Association of Southeast Asian Nations (ASEAN) banks. In some instances, it was to show how the report reflected on the company in question and to press for improvement in the lagging areas. For banks not included in the report, it was to encourage them with best-in-class examples to follow suit.

Sharing the report with Mr Bakhshi, the CEO of ICICI Bank, we were hoping that the bank could be one of the leaders in India. This was followed by a meeting with the responsible team. We were encouraged by their openness to share, as they provided an overview of their activities, challenges and projects in motion. For example, the bank has significantly increased solar production onsite (up 70% from fiscal year 2020 to 2021 alone); it is trying to keep emissions intensity flat; and has begun a lending checklist for environmental and social risks in 14 key sectors.

ICICI Bank has also expanded its ESG team with a revised governance structure to support it. As we continue to engage on these ESG matters, we believe this has been made easier by the close relationship we have built with the senior management team over the past five years. Moreover, these regular meetings and engagement efforts have strengthened our view on the quality of the bank's culture and governance standards. We remain patient, long-term owners and look forward to maintaining the relationship with ICICI Bank as it continues to improve its trajectory.

Focused, sub-industry analysis is key

Evaluating ESG factors is part of our risk-mitigation approach. We do not apply a check-box approach as we understand that the materiality of specific ESG factors will differ from company to company and from time to time.

Our initial research and analysis include an evaluation of a company's performance against points that are relevant to each key stakeholder group (broadly — employees, customers, suppliers and society at large, which includes the environment). Keen readers will have noticed that the stakeholder set here doesn't include shareholders. This is because our assessment of governance standards is separate from our analysis of a company's performance vis-à-vis these other stakeholders.

A typical assessment includes 25-35 questions that are tailored for the specific sub-industry in which the company operates. We glean better insights by doing this for directly comparable peers, (i.e. comparing Personal Care businesses, or Property & Casualty insurers, is likely to yield better results than comparing Consumer Discretionary or Financial Services firms). Furthermore, we tend to assign one (or maybe two) analysts to look at a single sub-industry, thus enhancing his or her ability to compare and contrast. Typically, the analyst looks at the global best-in-class company in that sector as well, to set

[5] https://freebeacon.com/latest-news/how-tobacco-companies-are-crushing-esg-ratings/
[6] https://www.knowesg.com/esg-ratings/british-american-tobacco-p-l-c

the benchmark. This evaluation process provides us with a baseline understanding of how the company treats its key stakeholders and identifies areas that may require further research and engagement.

Targeted engagement and follow-up

The next step, unsurprisingly, is to engage with companies on topics that have been identified. Admittedly, most of our engagements tend to be focused on governance-related matters. However, there are many instances where we have engaged on environmental or social issues, and this is a trend that we expect to accelerate as our own understanding of the key issues improves.

Some recent examples of our engagements include:

- **Alsea**

Alsea S.A.B. de C.V. is Latin America's leading Quick Service Restaurant ("QSR") operator with over 4,300 stores. It is responsible for managing brands like Starbucks, Domino's and Burger King in countries such as Mexico (its home market), Colombia, Chile and even Western European countries like Spain, the Netherlands and France.

We have known the company for many years (our first meeting with them was in 2007). We admired the way the founders, three brothers who initially started as franchisees for one Domino's store in the '90s, had built the business. Their track record of growing consistently and generating significant operating cash flows is commendable – over the past 10 years, the company has grown sales more than three-fold and earnings over six-fold in US dollar terms.

We have owned the business through some volatile periods, including the Covid-19 pandemic. Our engagement focus over this time was on succession planning and capital allocation. For example, we noticed an increase in senior management churn, with four CEOs appointed in eight years, which raised concerns about the stability and direction of the company.

We were particularly disappointed with the appointment of Armando Torrado as CEO (one of the three founder brothers). To us, this raised questions about whether the company's attempts at attracting talented professionals had failed. Further, we were uncomfortable with the board's strategy of using acquisitions to drive growth, potentially putting the company at risk. This was borne out by Alsea's experience during the global pandemic, when it had to approach its lenders to arrange a waiver on interest payments while its shops were shut.

We had hoped that this would change the board's mind about using acquisitions and leverage to drive further growth. In this regard, we wrote a letter to the main founder, Alberto Torrado, in July 2022. He responded immediately and asked us to meet with the new interim CEO (his brother) and a longstanding independent board member.

In October 2022 we visited Mexico and met with Armando Torrado, the new CEO, and Leon Eskenazi, an independent director who has been on the board for nearly a decade. The two provided us with an honest and detailed overview of the recent leadership changes. They assured us that the company is committed to maintaining strong corporate governance practices and has implemented measures to ensure more stability in the senior management. Armando's top priority, as per the board, is to groom a capable successor. They also provided us with an overview of the company's acquisition strategy and the steps they were taking to mitigate potential risks associated with leverage.

Overall, we were satisfied with the explanations. While we still have concerns, we have been encouraged by the steps they are taking to address these issues. In addition, now with the financial pressure caused by Covid-19 behind us, we have also turned our attention towards understanding the company's treatment of customers, employees and suppliers better. We are broadly impressed by the company's performance in several key areas (diversity, safety, nutrition, supply chain and the environment). However, there are still specific areas we have identified for further improvement. We will continue to monitor the company's progress and engage with management and the board as appropriate.

- **Astra**

At Indonesia's Astra International, a subsidiary of Jardine Matheson (JM), the issues relate to palm oil (80%-owned Astra Agro Lestari) and coal mining (60%-owned United Tractors). United Tractors holds the Komatsu machinery franchise for Indonesia, owns coal mines directly and does coal contract mining for other companies. These have long been concerns for us from both environmental and social aspects, and in recent years we have implemented stricter thresholds on coal activity in our portfolios.

Astra Agro Lestari (AAL) accounts for 4-5% of Astra's net profit (just 1-2% at the JM level), while United Tractors (UT) is more significant, accounting for 35-40% of Astra's profits (and 10-12% at JM). Directly held coal mining accounts for 2% of Jardine profits, while overall coal mining exposure is 6% including contract mining.[7]

To our questions about palm oil, JM said that AAL operates in line with European Palm Oil Alliance (EPOA) standards. That means no deforestation, no peat development and no exploitation. The EPOA has now been supplanted by Sustainable Palm Oil Choice, with similar compliance requirements.

Astra's plantations are certified by Indonesia Sustainable Palm Oil as compliant too, but not by the Roundtable on Sustainable Palm Oil (RSPO), an international organisation with Unilever and the World Wildlife Fund (WWF) as founding members. This is despite Astra's global client base. Jardine knows it can do better and is working to improve.

[7] Calculations by FSSA based on company annual reports.

Though Astra (and Jardine Cycle & Carriage) have been producing sustainability reports since 2017, we found the disclosure lacking with no greenhouse gas (GHG) emissions data nor any clear commitment on future targets. With the increasing contribution from the palm oil and coal businesses to Astra's profits and the impact this would have on the group's returns (dilutive while also being more unpredictable), we decided to exit our position in 2021. Shortly afterwards, the company published its GHG data for the first time (using 2019 figures) while also making a series of commitments to 2030 in their latest reports.

Astra has stated that it will not acquire any more coal assets and highlighted 10 sustainability aspirations. These include hard targets, such as reducing scope 1 and 2 GHG emissions by 30%, at least 50% renewable energy use for its internal needs and a 15% reduction in water intensity. Overall, Astra expects all coal-related revenues to account for less than 12% (from 22%) of overall sales by 2030, of which we will continue to hold them to a 10% or less revenue from coal threshold.

• Anta

Anta Sports is the domestic market leader in Chinese sportswear, operating well-known sportswear brands like Anta, FILA and Descente in China, as well as Wilson, Salomon and Arc'teryx on a global basis. Having followed Anta Sports since its initial public offering (IPO) in 2007, we have spent the past 15 years visiting the company and engaging in frequent dialogue with management to deepen our understanding of its franchise and build conviction in the quality of its management.

We have been impressed by Chairman Ding Shizhong's long-term vision and the management team's execution. We believe this combination of long-term owners, with the Ding family holding over half the shares, and well-incentivised professional managers, including high-profile hires from Nike, Reebok and Lululemon, has been vital in driving Anta's success. Long-dated share options (10 years) and restricted shares (vesting over 5 years) were allocated to its top managers, which strongly aligns their interests with Anta's long-term success. We think it is a testament of the management's belief in Anta's long-term prospects that a large part of the options awarded back in 2010 were only exercised in 2020.

We became shareholders of Anta Sports in July 2020, marking the start of our official engagement. Through a series of meetings with Anta's management (including the chairman, CFO and sustainability team), and a letter written directly to the chairman, we engaged with the company on a range of issues. These included supply chain management, workplace diversity, internal processes to combat corruption, management compensation and auditor independence. Given the open and proactive response we received, we believe the company is genuinely interested in improving its ESG practices and becoming a leader in sustainability issues.

We believe that Anta has made progress on a range of ESG topics over the years:

1. In December 2021 Anta established a sustainability committee to formulate and review its sustainability targets, and became the first Chinese sportswear company to pledge to carbon neutrality by 2050. It has also committed to a range of other sustainability goals, including the use of recyclable materials and biodiversity conservation, which have been incorporated into the management's Key Performance Indicators. Anta now monitors the sustainability of its suppliers, including water usage and emissions levels.

2. Anta has announced a target of at least 40% women among its executives at director grade and above by 2030. Following our engagements on the board's diversity and the independence of its directors, Anta announced the appointment of Ms Xia Lian to the board, being the second female director appointed by Anta in the last two years.

3. In 2019, Anta was the first Chinese sportswear company to join the Better Cotton Initiative, and increased efforts around supplier transparency as a result.[8] Although it has now exited the programme due to political pressures on sourcing areas, it swiftly pledged to look for alternatives. It joined the UN Global Compact initiative in November 2021 and has committed to reporting on its alignment to the 10 principles. It has also joined the Sustainable Apparel Coalition and the Science Based Targets initiative. Anta is also encouraging its suppliers to align to the Higg Index, a sustainability self-assessment tool to monitor environmental and social impact.

While Anta's progress is encouraging, we believe that no company is perfect. We appreciate the transparency of Anta's chairman, who openly admits to the company's steep learning curve and acknowledges that there is more to be done. This includes the publication of Scope 3 emissions data and a comprehensive map of its supply chain.

We believe our access to Anta's top management enables us to better understand the company's ESG approach and monitor its progress, which is distinctively different to our experiences engaging with other sportswear companies in China. We look forward to continuing our dialogue with Anta's management in the upcoming months and years, as they continue to deepen their ESG focus.

Conclusion

At FSSA we assess environmental and social risks and opportunities as part of our analysis of a company's long-term fundamentals. We believe management

[8] https://www.ispo.com/en/trends/anta-sports-first-company-china-join-better-cotton-initiative

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 a company's growth prospects without a strong appreciation for the sustainability headwinds and tailwinds?

It is for this reason that we emphasise a common-sense, rather than a box-ticking, approach to sustainability. To us, the spirit matters more than the letter of the law — and by that we mean we prefer to invest alongside a management team that acknowledges its faults and is genuine in its desire to improve its standards, rather than one that produces glossy "Sustainability Reports" but continues to abuse the environment or society. Broadly, we assess the key environmental and social risks for the industry in which a business operates and whether the company in question stands to benefit or lose from these trends. We prefer companies that offer products and services benefiting from customers who are growing increasingly conscious of environmental and social impacts. We then look for a management team that is attuned to these long-term challenges, or at a minimum, is willing and open to engagement where we can perhaps help them on their journey.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 30th April 2024 or otherwise noted.