FSSA Investment Managers

December 2021

Quarterly Manager Views

FSSA Global Emerging Markets Equities Focus

Mutations, it would seem, are not unique to the virus. Starting with some housekeeping, we always end our letters seeking feedback from our regular readers. Two common points we have received is that our letters are generally too long and the semi-annual schedule we have adhered to in the past is too infrequent. Therefore, we are pleased to implement a change in the format and cadence of our communications. In this new version, our letters will focus on portfolio updates and brief thoughts on pertinent topics. Moreover, we aim to write on a quarterly basis. This, we hope, will be more suited to the wishes of regular readers.

Since our last update, the initial public offering (IPO) frenzy we have observed for the past 12-18 months has continued unabated. This is especially true in India where there have been around 100 IPOs so far this year. These newly-listed entities have raised a combined USD 12bn from investors and yet only 20 of them reported a net profit of more than USD 10m![1] Undoubtedly, some of these companies will grow into their valuations and, in hindsight, a few might even seem like bargains today. However, the asymmetry of information in any IPO process means that new shareholders are at a disadvantage. Many IPO prospects often fail to answer the following question convincingly: why would a knowledgeable seller, sell part of their business to a less-knowledgeable, non-strategic buyer?

A great many of the cohort listing these days are what we would describe as growth traps. We referred to these businesses in our December 2020 update. Growth traps are profitless companies operating in industries with weak entry barriers and/or few competitive advantages that seek growth above all else, be it in terms of users, transactions, "GMV"[2], or just plain revenues. Showing some kind of growth (even if it is unprofitable) is essential for these businesses to raise capital, which can then be used to fuel more unprofitable growth which again allows them to raise even more capital, and so on.

Warren Buffett, in a 2001 speech to students at the University of Georgia, used the analogy of the auto industry

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For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document for each Fund.

If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

[1] Source: Bloomberg, as at 30 November 2021

[2] Gross Merchandise Value

at the beginning of the 20th century to describe how most fast-growing businesses fail to deliver the desired returns over the long term. While the invention of the automobile and its subsequent impact on society was significant, understanding a business' economic characteristics is different to predicting the success of an industry. Out of the 2,000 American auto companies that existed in the 1920s, only three survived into the next century and — to Buffett's point — their performance over time has been questionable.

At the current point in time, many investors tend to reward new company listings with a valuation premium that signals sustainable growth and returns. While we have no doubt that some of them will eventually emerge as sustainable, the absence of any meaningful free cash flow in many of these companies makes us cautious and we believe that over the long term something will have to give. There may however already be some cracks, as the recent IPO of Paytm — the much-hyped Indian fintech IPO — has shown. Since the company's establishment in 2010, the business has consumed more than USD 2bn of capital but has only generated cumulative revenues of USD 400m — and profit is non-existent as one might have expected. Yet to our surprise, the company managed to raise USD 2.5bn at their recent IPO, valuing the company at USD 20bn. After its listing in November the share price slumped, initially by more than a third of its value. However, we would view this as a healthy sign — normalisation might finally be happening after an unusually speculative 12-18 month stretch.

Changes to the portfolio

While the average newly-listed company in India may not have particularly attractive business fundamentals, we believe active asset management has always been about finding the diamonds in the rough and India is still a very fertile hunting ground for long-term investors. Since our last update we have initiated a new position in India, which in contrast to most of those newly-listed companies is a highly profitable and cash-generating company. As a reminder of our investment approach, we specifically focus on strong management teams and quality franchises with defensive characteristics such as high returns on invested capital (ROIC) and recurring cash flows. Often, these businesses can be found among the dominant consumer, financial or service companies in the less developed parts of the world. Not only are penetration rates low for many goods and services, which provide a favourable long-term secular demand backdrop, but the high level of informality in many of these countries also raises the barriers to entry substantially. This often facilitates a benign competitive environment that allows many of the dominant companies (with a brand, distribution or scale advantage) to generate high margins and high returns and, as a result, strong free cash flow. We believe the latest addition to the portfolio, financial services company Computer Age Management Service (CAMS) in India, is one such example.

CAMS is India's largest registrar and transfer agent (RTA) of mutual funds with a domestic market share of 70%. RTAs offer outsourced back-office solutions to asset management companies and is a critical part of the industry as it allows mutual funds to focus on their core business and at the same time reduce costs by leveraging the scale of the RTA. Mr V Shankar and his wife Sudha founded CAMS in early 1988 as a Software Development and Computer Education business. Mr Shankar had worked at Ponds (later acquired by Unilever) after his MBA and was most intrigued by the "data processing" segment in his rotation through the divisions, hence the idea of starting CAMS with his wife, a programmer. For the first five years, they focused mainly on software education, with a smaller information technology (IT) services arm which implemented enterprise resource planning (ERP) software. However, in 1993 after the Indian mutual fund industry opened up, CAMS applied for an RTA licence and slowly started to expand its operations. While the industry was highly competitive in the early days, what worked well for CAMS was its relentless focus on customer service and the continuous addition of new features for its customers. This continues to differentiate the company today after almost three decades in the industry — and is an integral part of its culture.

CAMS charges customers a fee based on the assets under management (AUM) it handles, which in a way can be thought of as a royalty on the growth of the Indian asset management industry. While the industry has been growing rapidly in the last 5-10 years, it is still in the infant stages and should have a long runway ahead, driven by the emergent middle class in India and the increased financialisation of these consumers. Of course, its dependency on the AUM of its clients makes the business model somewhat cyclical, but this is partly cushioned by CAMS' telescopic fee structures. This means that when the size of assets managed by its customers fall, the fees they are charged actually rises. More importantly, even if there are temporary fluctuations in AUM from time to time, the longer-term trajectory for the Indian mutual fund industry continues to look very bright. Today, mutual funds are only a small part of household financial assets at 8% and there are just 50 million unique investor accounts in India (compared to a population of 1.4 billion people).[3] In terms of AUM as a percentage of a country's gross domestic product (GDP) India is at 12% versus Japan at 40%, the UK at 67%, Brazil at 68% and the US at 120%.[4] As household savings increase and money is brought into the financial system, we believe the penetration rate should

[3] Source: National Stock Exchange of India (NSE), as at 25 October 2021

[4] Source: Association of Mutual Funds in India (AMFI), World Bank, Jefferies, data as at 2019

naturally rise and provide strong support to CAMS' long-term growth potential.

From an industry structure perspective, amid ongoing consolidation for the past two decades and with its 70% market share, CAMS is now the dominant company in a two-player market. The company has long-standing relationships with the highest-quality companies in the Indian mutual funds industry and has the largest physical presence across India through its branch network. In addition, it has built a strong technology platform on which it is now launching new businesses, including Alternative Investment Funds (AIFs), an Insurance Repository, know-your-customer (KYC) registrations and Account Aggregation services, among others. These new businesses are still small and only make up 6-8% of the total business today but could become more meaningful over time.

Contrary to what one might think, the RTA industry is not a typical cost-leadership business, as headline pricing alone has not been the primary driver of market share in the past (prices are fairly standardised across the industry). Instead, high switching costs (including time, risk and reputation) are the main consideration. Therefore, as long as an RTA provides good service and meets expectations, there is little incentive for clients to switch providers. On the other hand, if asset managers experience poor service which results in compliance lapses or end-customer dissatisfaction (and, ultimately, reputational damage), they are highly incentivised to switch, given the potential business risk.

We believe it is therefore essential for any dominant company in the RTA industry not to abuse its position or become complacent. While switching costs as an entry barrier can be a fantastic moat, often the best way to protect it is to continuously reinvest in improving the service and integrate further into customers' processes. And this is exactly what CAMS has been doing. The company is well known for its customer service and the addition of new features for mutual funds they work with. To share a few examples, they were the first to start digitising records in the mid-1990s given their background in software services and education, and they revolutionised customer service with a 24-hour turnaround time for complaints, versus the norm then of 30 days. This is also the reason that CAMS has never lost a customer (the average length of its customer relationship is 19 years). It is the only player in the industry that has gained market share consistently over the past 20 years, evidencing the sticky nature of its business and the reluctance of customers to switch.

While the founder of the business, Mr Shankar, stepped back from the business a decade ago, the governance track record continues to impress. CAMS has remained ahead of the curve and its risk-aware culture has helped it gain share and maintain its leadership position. We have been particularly impressed with the senior management team (who we have spoken to four times over the past year) and would characterise them as high quality, led by the passionate and sensible CEO, Mr Anuj Kumar. While operational execution has been strong under his tenure, he remains relatively unproven from a capital allocation perspective, which over time could become a more serious question given the superior profitability of CAMS' RTA business and the limited re-investment opportunities in the existing business. Reassuringly, we believe the management team at CAMS are being thoughtful about the issue and not likely to make any decisions to change the return profile of the company. In a recent conversation with the management team, they articulated a clear framework of priorities and investment criteria that supports this view.

The outcome of all the variables discussed above is an extremely profitable and in our view attractive business. While the revenues may be somewhat cyclical, the balance sheet is highly defensive with a solid net cash position — one of the key features that we look for in cyclical companies. In addition, CAMS' earnings before interest and taxation (EBIT) margins have been climbing towards 35% in recent years and given its favourable working capital cycle (the company receives cash upfront from its customers but pays suppliers with a delay), CAMS has been able to cover all of its capital expenditure over the past 15 years from internally-generated cash. This has resulted in ROICs exceeding 100%, which we believe will continue to rise in the coming years, driven by ongoing margin expansion from further automation of data processes. At the time of purchase CAMS was trading at a free cash flow yield of slightly below 3%. While this is clearly not a bargain, we expect CAMS to continue generating solid cash flow growth for many years as the market is still vastly underpenetrated. This should support longer-term share price appreciation and we look forward to holding this company long into the future.

Outlook

As we look towards 2022, we continue to be optimistic about the prospects of our holdings. Despite ongoing headwinds — whether from the pandemic, or concerns about higher inflation, or a stock market that is hooked on stimulus that appears to be withdrawing — we believe these factors are transitory in nature and should eventually stabilise.

More importantly, the FSSA GEM Focus portfolio is made up of 40 high-quality companies with a track record of navigating challenging environments as demonstrated over the past two years, which allows us to sleep well at night. The average return on invested capital of our holdings[5] is expected to rise to 53% in the coming years, indicating that for every dollar invested into their operations the payback period is less than two years, which we view as attractive. In addition, we continue to expect our holdings to deliver 14-15% annualised earnings and free cash flow growth over the mid-to-long term, which should mean resilience in the face of adverse headwinds.

Strong competitive advantages, defensive balance sheets, attractive growth opportunities and solid management teams — the core, timeless pillars of our investment philosophy — should continue to make our holdings well positioned to generate attractive risk-adjusted returns in the coming years and will never go out of fashion for long-term minded investors like us.

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.

[5] Non-financial holdings

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 November 2021 or otherwise noted.

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