SKERRYVORE GLOBAL EMERGING MARKETS EQUITY STRATEGIES

Research Review

2022

Skerryvore

bennbridge

Contents

Front cover: Lighthouse on the coast at Zhuhai, Guangdong Province, China

For professional investors only

Stock examples

The information provided in this document relating to specific stock examples should not be considered a recommendation to buy or sell any particular security.

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Foreword

Our strategy has always had low levels of turnover, so portfolio activity alone does not provide a full picture of the team's wide-ranging research effort. This research review aims to give a greater insight into how we assess businesses and decide which to add to our emerging market watchlist and strategies.

Some of the research activity discussed here has led to portfolio change; other areas may require further work, which can sometimes lead to a decision not to invest in a particular company or sector. However, it is important that we continuously challenge ourselves to understand and assess new opportunities across all of the regions and sectors making up our investment universe and avoid falling in love with companies we already own.

Maintaining an open mind helps ensure that the portfolios we manage can meet the challenge of the future and increases the likelihood of them meeting our long-term absolute return aspirations.

What's in this Review?

The often quoted, 'May you live in interesting times', came to mind this year as several events many developed market investors haven't experienced in decades – war, inflation, currency collapses and rising autocracy – came to the fore. We are used to seeing crises in emerging markets, but the rest of the world is much less familiar with such 'interesting times'. What has been different this year is the global nature of these woes; it's an unusual year when the Mexican peso and Brazilian real are two of the best-performing currencies against the dollar. The Japanese yen, Swedish krona and British pound are among the worst[1].

Aside from highlighting our research this review also makes the case for investing in emerging markets. We believe, and can evidence, that our universe contains some of the best businesses anywhere in the world, something highlighted in **'Global emerging leaders – it's not all about low-cost'**.

The management talent we come across through our company meetings illustrates that the developed world is not exclusively where some of the best management teams are based. TSMC is a good example of this; see **'A closer look at TSMC'**. As long-term investors we also believe the demographic tailwinds mentioned in **'India's homegrown winners'** will pay dividends, but simply taking what has worked in Europe or the United States and pushing it in India or China may not be the answer.

Our work on and conversations with management teams have also brought to mind the depth of experience in handling tough times. Inflation, which hasn't reared its ugly head for developed countries in any meaningful way since the 1970s, is something that emerging markets live with constantly. This skillset is discussed in **'The importance of pricing power'**. We also think a lot about resilience, the ability of a business to withstand external shocks. For a long time, consumer staples have formed the backbone of our portfolio because they are a part of people's everyday lives whatever the weather. Our work on computer gaming in **'Opportunities in gaming'** has shown that entertainment may also display some of these characteristics.

We hope these articles are useful in giving some insight into what we have been doing over the past year and we would welcome any comments or questions you might have.

1. Bloomberg.

Global Emerging Leaders – It's not all about low-cost

China is often referred to as 'the factory of the world'. Its manufacturing prowess was in part built on cheap labour, tax incentives and weak environmental regulations, which enabled it for a long time to offer the lowest-cost production. However, a decade of high wage inflation in China shows that such advantages don't always last forever.

So how can manufacturers build an enduring competitive advantage? One answer is to establish expertise and a reputation that make customers loathe to shop around for a better deal.

Here, we introduce two companies that have had significant success in using this approach to become global leaders in their field.

Advantech – Enabling an Intelligent Planet

Advantech was founded in Taiwan in 1981 by three ex-Hewlett Packard engineers. One of the founders, K.C. Liu, continues to run the business as executive chairman and controls over 30% of the company[2].

From its early days, Advantech's success was built on solving problems for its customers. Their initial focus was on industrial computers that perform specific tasks in challenging operating environments, requiring high performance whether it is freezing cold, boiling hot or torrential rain. Unlike for consumer PCs, where cost and brand were the key to success, in industrial PCs it was customisation and reliability that won the day. Whereas consumer PC manufacturers have traded market share and seen profitability dwindle, Advantech has quietly cornered 30% of the industrial PC market[3].

An initial focus on one core competence is now reaping bigger rewards for Advantech. A natural evolution of this business was industrial automation (IA), which involves using a variety of capital equipment from different vendors to create a manufacturing product line. IA solutions enable all these components to be monitored and tailored to work in harmony with one another and improve the overall operational efficiency of the manufacturing facility.

Now, as more and more everyday objects are becoming connected to the internet, capturing and analysing their data has become another new industry. This so-called 'Internet of Things' (IoT) fits perfectly with Advantech's skillset. They are now working with customers to provide a broad range of innovative solutions such as reducing the energy consumption of a building, improving traffic flow in a city and remotely monitoring healthcare patients.

WEG – Driving Efficiency and Sustainability

WEG was founded in 1961 in Brazil and takes its name from the initials of its three founders, the families of whom still control the company. Like Advantech, WEG's expertise in a particular niche brought it early success.

WEG is one of the world's leading producers of electric motors, used in everything from a small electric fan to a large high-voltage power turbine.

Low cost was important in the company's early days but, like Advantech, long-term success in this field is forged by building customer trust in your products.

Over the years, WEG's engineering proficiency has led to continuous improvements in the energy efficiency of its motors and enabled the company to move into adjacent markets such as transformers for power distribution. In recent years, their knowledge leadership in electric motors and power transmission has given them an early-mover advantage in various exciting new renewable energy-related product segments, including electric vehicle charging, energy storage solutions, solar equipment and wind turbines.

Trust Builds Loyalty

Shareholders in these two companies have been rewarded with consistently high growth and returns despite being exposed to the ups and downs of the economic cycle. Advantech has grown revenues at a compound annual growth rate (CAGR) of 9% over the past 10 years in US dollar (USD) terms. WEG has grown USD revenues over the same period at 6% – a period that has included a protracted Brazilian recession and a slump in the Brazilian currency[4].

What Advantech and WEG have in common is an engineering-led culture that strives to provide the best products in a particular niche. A reputation for reliability and a culture built on partnership with their network of distributors and customers have allowed these firms to become leaders in new growth markets. Success was not a case of undercutting their rivals. It was about creating a loyal customer base that meant they themselves weren't undercut.

Across the emerging market space, there are many low-cost leaders. We continue to search for those that, like Advantech and WEG, can take the next step by turning a low-cost opportunity into a long-term sustainable competitive advantage.

2. Bloomberg.
3. Advantech Annual Report 2021.
4. Capital IQ. Calculation is based on revenue from 2012 to 2022 (2022 revenue estimates are Capital IQ consensus forecasts).

The Importance of Pricing Power

Investing in inflation-prone emerging markets means seeking companies with strong pricing power. Understanding the source of that pricing power is essential when assessing franchise quality and management integrity.

Sources of Pricing Power We Don't Like:

- **Bribing politicians and/or regulators**
  This is risky because permissive regulation can change, and corruption can be exposed, with the guilty being punished.

- **Abuse of state-granted monopolies**
  Monopolies are good for oligarchs but bad for consumers. Lower prices generally benefit everyone except shareholders so where these are sustained one wonders how this is achieved.

- **Exploitation of regulatory arbitrage**
  Many emerging market businesses operate in a manner that would not be permitted in more highly regulated parts of the world. We try to avoid exposing clients to practices that are likely to result in losses as regulations inevitably strengthen over time.

Sources of Pricing Power We Do Like:

- **Pricing power from building brands**
  Not all brands are created equal. We look for evidence of both strong and defendable margins. High-competition categories whose pricing behaves more like commodities (e.g. sugar, rice, bread) don't meet this test. Consolidated categories with strong brands and high distribution barriers to entry (e.g. **Heineken** and **Coca-Cola's** operations across emerging markets) do.

- **Pricing power from earning trust**
  In sectors where the cost of failure is high, a good reputation can deliver pricing power.

  Alex Hseih, founder of **Voltronic**, the Taiwanese manufacturer of uninterruptible power supply (UPS) units, built the business on the back of his team's reputation and experience. Customers trust Voltronic due to the quality of its work but also, crucially, its commitment to never launching products that compete with its customers.

  This has allowed the business to post impressive growth and we see increasing numbers of brand-owning companies turn to Voltronic as their outsourcing partner.

  Others that play to this theme are **Syngene** (India) and **Tigermed** (China), which are forging long-term relationships with multinational innovative pharmaceutical companies built on trust.

- **Pricing power from continuous investment in IP**
  In some areas, companies willing to invest in research and development (R&D) can carve out positions of strong pricing power.

  An obvious example is **TSMC**, the world's largest semiconductor manufacturer, which has been willing to consistently spend heavily on leading-edge capabilities despite the cyclical nature of its market. This far-sighted approach has enabled the company to establish and maintain a leadership position.

  Tata Consultancy Services' continuous investment in its people has allowed it to move steadily up the value chain – it began life as a lower-cost alternative to developed-world IT consultants but has evolved into a very profitable global player.

A Closer Look at Retailers During Inflation

Well-managed retailers, which often benefit from inflation, have also been a good hunting ground for our philosophy – especially if they use an efficient business model to generate operating leverage and drive earnings, as **Jerónimo Martins** and **FEMSA** do.

Jerónimo Martins has expanded beyond its home country of Portugal to become the largest retailer in Poland and also has operations in Colombia. Management invested in an extensive range of affordable, quality private label products, providing a cheaper alternative to branded products that can be critical to a cash-strapped consumer.

FEMSA operates the Oxxo chain of convenience stores in Mexico. Its adept execution of a large-scale store roll-out has brought it scale advantages in a country where informal retail remains a significant player. Oxxo also offers services such as basic banking and ecommerce collection, enhancing the 'convenience' of its stores, so customers keep coming back even if Oxxo doesn't always offer the lowest price.

When prices are rising, retailers must tread a fine line between maintaining profitability and losing customers. Jerónimo Martins and FEMSA's strategies of low price and convenience are enabling them and their customers to weather the latest inflationary storm.

Summary

A proven ability to create intellectual property, ownership of strong brands and well-managed retail franchises are some of the attributes of companies we have seen navigate previous periods of high inflation.

We avoid companies we suspect of abusing dominant market positions or bribing politicians or regulators, and those we worry may be exploiting weak environmental or labour laws. Protecting clients from these types of behaviours is an important component of our risk-aware approach to investing in emerging markets.

A Closer Look at TSMC

By their late 50s, most people's thoughts turn towards retirement and perhaps a slower pace of life. Not Morris Chang. At 57, and after 25 years at Texas Instruments, he agreed to a request from Sun Yun-Suan, Taiwan's premier, to become the chairman of the Industrial Technology Research Institute in Taiwan. He quickly realised there were some brilliant people there but they lacked commercial purpose and so the Taiwan Semiconductor Manufacturing Company (TSMC) was born[5].

Customers First

Chang favoured a very simple ethos – customers first. As the business grew TSMC could have designed its own chips, but he understood how important trust and a lack of conflicts were. The values laid out by TSMC are clear, simple and most importantly true to the business:

'Since the company was founded, we have treated our customers as partners and have never competed against them. This policy is the key to our current success and will be crucial to our continued growth. At TSMC, customers come first. Their success is our success, and we value their ability to compete as we value our own[6].'

A further insight was around pricing. The most advanced chips are wildly expensive to produce, and the start-up costs would mean an uneconomical cost to customers.

Taking a longer-term view, Chang knew that if you could get to scale the cost per chip would drop radically as the large, fixed costs were spread over a greater volume. The quality of the chips would also improve, giving greater yields. As a result, the first customers for each leading generation of processor actually pay less than the cost to produce them, but this is another investment that the company consciously makes.

5. Cadence (6 May 2022). *An Interview with Morris Chang.* https://community.cadence.com/cadence_blogs_8/b/breakfast-bytes/posts/morrischang
6. TSMC. *Values and Business Philosophy.* www.tsmc.com/english/aboutTSMC/values

Managing Change

For shareholders in TSMC, Morris Chang seemed to combine the skills of a brilliant operator and tactician with those of an investor building a cultural and process advantage on top of a clever business model, including some huge capital investments to continue to build capacity. The challenge, however, came when the business was looking for a successor.

Chang stepped down as CEO in 2004, handing over the reins to Rick Tsai, a long-time lieutenant in the business. When the financial crisis hit in 2008 the company cut its investments, which prompted Chang, now aged 78, to come back and turn the taps back on. It was the rise of the mobile phone, and particularly the iPhone, that helped turbocharge TSMC's growth from $5.5 billion USD in 2009 to nearly $22 billion at the end of 2021. Chang stepped down again in 2018, handing over to two of his most trusted managers who had worked as co-CEOs since 2013[7]. During the pandemic, when many others were cutting investments, TSMC's capital expenditure increased significantly.

TSMC is one of the best businesses we have come across globally, yet there are a number of risks. At the end of 2021, 96% of its assets were located in Taiwan, so China's unwillingness to rule out taking the island by force creates a significant danger. We can't predict the future but note that TSMC has recently announced an expansion in Arizona that will see it manufacture leading-edge chips in the US for the first time from 2024[8]. It will, however, be many years before the company significantly shifts its weight of production and this does limit the size of the position we would be willing to hold.

Watching the Alternatives

In the meantime we have identified other companies that will also benefit from a world in which demand for semiconductors will only increase. There are several in Korea that we think are very interesting, and we have looked closely at **ASML**, a company based in the Netherlands, which now has a monopoly on the leading-edge tools required to 'print' chips.

The other alternative for us is **Samsung Electronics** based in Korea, which also provides semiconductor manufacturing for third parties. Despite the obvious allure of a company not based in Taiwan, we have been put off by its model: Samsung makes its own chips and electronic devices that compete directly with its customers.

Although there are strong incentives in emerging markets to take shortcuts, the best management teams need not do this to succeed. Instead, they recognise the value of integrity and the reputational advantage it brings, which we think is far-sighted and fair-minded. Like any investment TSMC is not without risk but we believe the quality of this business makes it stand out globally.

7. Capital IQ.
8. Tom's Hardware (29 July 2022). *TSMC Completes Construction of 5nm Fab 21 in Arizona.* www.tomshardware.com/news/tsmc-fab-21-arizona

India's Homegrown Winners

India is expected to become the world's most populous country in 2023. By 2050, its population could increase by 256 million[9].

A Tailwind for Growth

With these demographics on its side, India presents an exciting long-term opportunity. Consumer names with strong brands and far-sighted management teams can benefit from structural growth in terms of both volumes and premiumisation. Local companies often have the initial edge when it comes to catering for Indian consumer preferences, but some multinational companies (MNCs) have learned to tailor their offerings.

A Brief History of MNCs in India

Foreign corporations have long recognised the growth opportunity in India. Indeed, the British East India Company, founded in 1600, is often cited as the world's first MNC[10]. Of the businesses that still exist, Standard Chartered opened its first banking branch in modern-day Kolkata in 1858, and Siemens and Goodyear Tires both established Indian subsidiaries in 1922.

The 1970s were challenging for overseas companies as the political landscape became more protectionist and insular. Many companies left after a 40% cap on foreign ownership in most sectors came into effect in 1974[11, 12].

9. UN (2022). *World Population Prospects 2022* www.un.org/development/desa/pd/content/World-Population-Prospects-2022
10. The Guardian (4 March 2015). *The East India Company: The original corporate raiders.* www.theguardian.com/world/2015/mar/04/east-india-company-original-corporate-raiders
11. Forbes India (14 August 2014). *Economic Milestone: Exit Of The MNCs (1977).* www.forbesindia.com/article/independence-day-special/economic-milestone-exit-of-the-mncs-(1977)/38431/1
12. In the 1990s, Coca-Cola bought its way back into the market and it still owns India's bestselling soft drink, Thums Up. The Economic Times (22 September 2022). *Soft drinks market: Thums Up hits a decade-high market share of 20%.* https://economictimes.indiatimes.com/industry/cons-products/thanda-matlab-thums-up/articleshow/94359829.cms

Far-sighted MNCs

Companies that decided to stay, diluting their ownership and allowing domestic investors to benefit from their growth, included **Unilever**, which had started shipping soap to India in 1888. It formed **Hindustan Unilever** (HUL) in 1956, among the first MNCs to offer equity to the Indian public[13]. Unilever also recognised the benefits of appointing Indians to manage the business, enabling it to build a distinct portfolio of brands tailored specifically for the Indian consumer. Today, HUL claims category leadership in 90% of its business[14].

A Domestic Leader with MNC Oversight

United Breweries is a strong, homegrown franchise that dominates its local market. Under the leadership of Vittal Mallya, the company consolidated the Indian beer market and launched its flagship Kingfisher brand in 1978, which is still the country's favourite beer.

More recently, **Heineken** has steadily increased its stake in United Breweries and is now the majority shareholder, highlighting the long-term opportunity for growth offered by low per-capita consumption and a shift towards premiumisation.

India remains a difficult country for a beer brewery, with laws on alcohol distribution and even enforced prohibition in some states. But with a well-managed, family-controlled MNC at the helm and a healthy net cash balance sheet, we are much more excited about its prospects.

Homegrown Winners

We have also found local consumer winners that are still owned by founding families who recognised the diverse needs of India's population and tailored their product offerings.

Godrej Consumer Products, originally a lock manufacturer, introduced the first Indian soap made from vegetable oil instead of animal fat in 1918. This embodied 'ahimsa', the ancient Indian principle of non-violence to all living beings, and was especially impactful at a time when Indians boycotted goods produced by British companies. Now it is the second-largest soap player behind HUL.

Another tradition is natural medicine, of which Ayurveda, designed to stabilise mental, physical and spiritual wellbeing, is the oldest and most popular[15]. **Dabur India** started with a mission to provide effective and affordable cures for ordinary people in 1884. Its Ayurvedic products continue to display strong positions in categories like hair care, health supplements and oral care, and it is well positioned to benefit from renewed interest in products made from natural ingredients[16].

Dabur and Godrej both have a family constitution setting out the rights and responsibilities of the ever-expanding families and clear oversight is provided through board representation. Both families recognised the need to professionalise management at an early stage to scale the business efficiently.

Holding All Companies to the Same High Bar

We firmly believe that the best companies in emerging markets can compete with the best companies anywhere in the world. To get exposure to companies that will benefit from India's demographic tailwinds, we look for strong brands and far-sighted management teams among both local names and multinationals that have successfully adapted to local consumer preferences. Many have to reside on our watchlist for now as valuations reflect this bright future. But if falling share prices give us the opportunity, we are ready to act.

13. Unilever - *HUL History*. www.hul.co.in/our-company/hul-history/#:~:text=In%20the%20summer%20of%201888,Moving%20Consumer%20Goods%20(FMCG).
14. HUL (18 November 2022). CEO Presentation - Capital Markets Day 2022.
15. Dabur UK – *About Ayurveda*. https://dabur.co.uk/about-ayurveda
16. Nielsen (June 2017). *But naturally! Going back to naturals in India's personal care segment*. www.nielsen.com/insights/2017/but-naturally-going-back-to-naturals-in-indias-personal-care-segment/

Opportunities in Gaming

Ever cheaper consumer electronics, including smartphones for less than $50, and data plans priced close to zero have allowed access to video games across the world. From the casual gamer playing *Candy Crush* to pass time to the hardcore veteran of *World of Warcraft*, gaming offers a fun way to spend time and money. Video games have many critics, but it is difficult to deny their popularity.

As emerging market investors, we have long favoured consumer companies for their ability to establish pricing power, generate consistent cash flows and grow alongside the populations they serve. Our research into the gaming industry, where we find high-margin software businesses with a growing customer base, has led us to see some parallels.

There are now over 6 billion smartphone users globally[17], relying on their devices for communication, work and entertainment. Americans, on average, spend nearly 5.5 hours per day on their phone[18]. Entertainment is a key part of that, often including significant gaming. Such rapid changes in our daily lives have come with concerns over screen time and its impact – concerns that have grown into regulation in several markets, including China and South Korea; and similar stories have come up in the US and Europe over the past 20 years. We are wary of such issues and aim to reflect these risks in our valuation work, but over the long term the industry seems likely to continue growing.

From Dabbler to Developer

From an investment standpoint we seek strong franchises, which involves a deeper look at industry structure. Distributors of games offer a shop front where dominance is built on a network effect. Companies like **Google** and **Apple** tend to dominate the global market because of their mobile operating systems. Console makers like **Nintendo**, **Sony** and **Microsoft** have also benefited from similar positions, but that ecosystem is evolving. We admire the world's largest gaming publishers, a sort of marketer for the industry. Scale provides resources and the ability to secure the best content for consumers. The world's largest games company by revenue, **Tencent**[19], started in the industry as a publisher but has since begun to develop games as well. Other large publishers started as developers; **Activision Blizzard** and **Electronic Arts** are good examples.

17. Oberlo (2022). *How many people have smartphones in 2022?* www.oberlo.com/statistics/how-many-people-have-smartphones
18. Deyan, G (13 October 2022). *How much time does the average American spend on their phone in 2022?* https://techjury.net/blog/how-much-time-does-the-average-american-spend-on-their-phone
19. Statista (25 November 2022). *Gaming revenue of leading public companies worldwide in 2021.* www.statista.com/statistics/421848/game-revenues-global-companies/

Developers are more like the boutiques of the industry. Some of the best have humble origins, hobbyists or gamers who set out to make better experiences. In the emerging markets universe, Korea stands out. Perhaps because there were so few locally translated titles, many young people in the 1980s and 90s began to adapt games from Japan and the US to the local language. Then they developed their own games based on local culture. Success stories include **Nexon** and **NCSoft**, but many smaller companies have also built good reputations with gamers. Other emerging markets such as Poland have quality developers, too. Resource requirements have grown over time, which has led to smaller teams tying up with or taking funds from larger firms. In those situations it's important the culture and autonomy of smaller teams be respected.

In gaming, like other parts of the entertainment industry, it is not easy to predict winners. Audience approval can be fickle. Fortunately, as investors, we can focus less on the fashion or popularity and more on the organisations from which they are produced. A long-term mindset is critical. Building a culture that retains talent is key. Diversifying profits improves resilience and maintaining a strong balance sheet creates flexibility. Studying these helps us identify the quality companies in this industry.

Nexon – A Compelling Prospect

Today our strategy has invested in Nexon, a Korean developer and operator listed in Japan. It was one of the first developers from Korea and has multiple enduring titles that continue to grow. Their largest success, *Dungeon & Fighter*, has over 850 million registered users globally and cumulative gross revenues over $20 billion[20]. Multiple titles diversify revenues and reduce the risks of concentration and sharp peaks and troughs around game launches. Nexon's long-term approach stems from the leadership of Owen Mahoney, who has focused the business and helped attract world-class developers, which should breed further success in the future. Mahoney is supported by the late founder's family and a cash-rich balance sheet. We see current valuations as compelling in the context of Nexon's current cash flows and growth prospects.

As always, we are highly engaged in trying to find companies we believe meet our threshold of quality. We are encouraged by a small few, but expect to see the opportunity set grow over time. The future looks bright for emerging market gaming.

20. Nexon (9 November 2022). Investor Presentation Q3 2022. Nexon Investor Relations.

About us

Introduction

The Skerryvore lighthouse marks a treacherous reef of rocks that lies off the west coast of Scotland, built to stand the test of time. Skerryvore Asset Management (Skerryvore) is an independent, employee-controlled investment partnership established in Edinburgh with BennBridge in 2019. The partnership was set up to create a business with the independence to pursue its own investment philosophy.

Our strategies aim to generate absolute long-term returns by investing responsibly in emerging markets. This is based on an unwavering focus on the quality of the businesses in which we invest. We believe in managing clients' money as we would our own, aligning our interests with our clients and never losing sight of the trust that is put in us to be responsible stewards of capital.

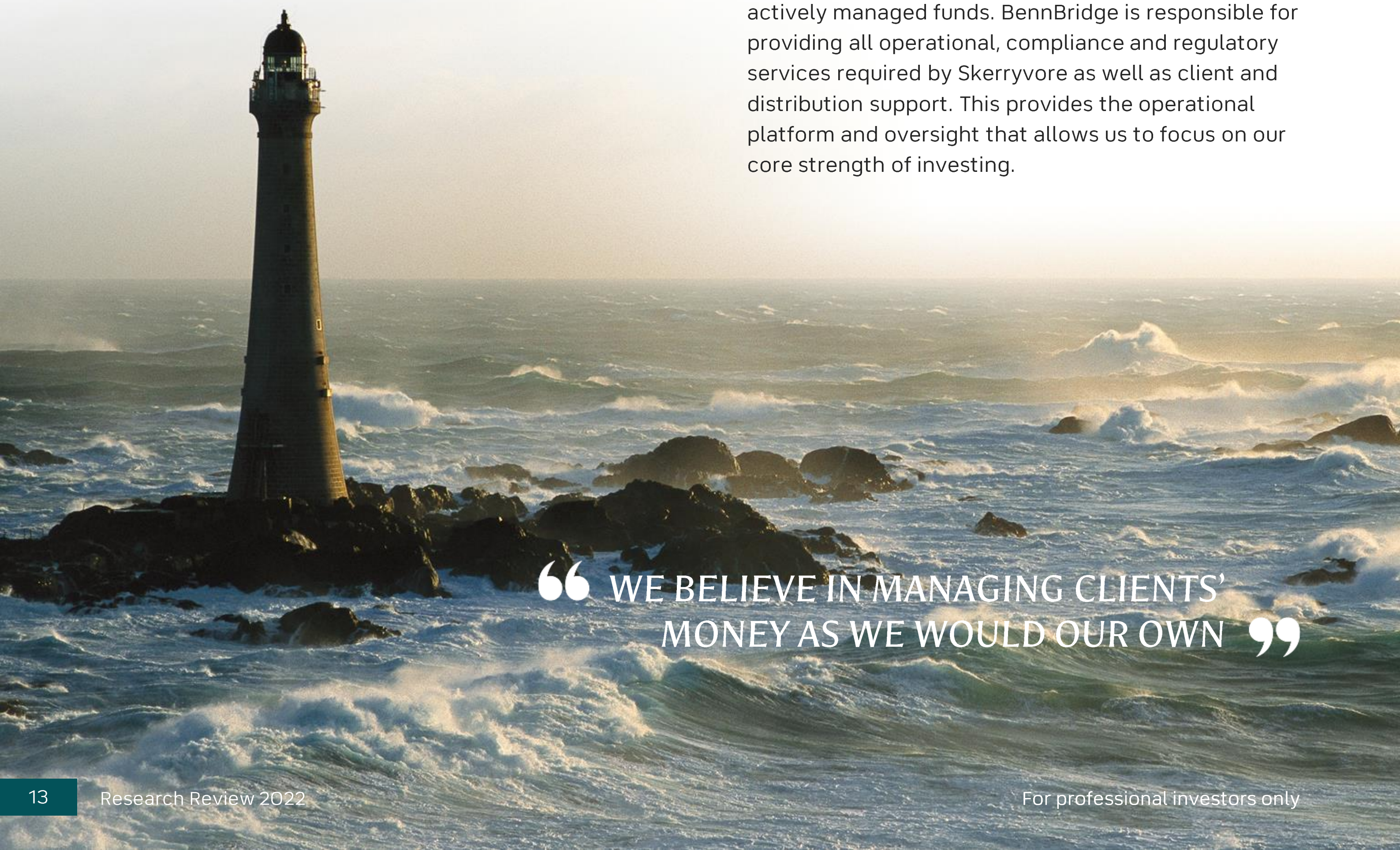
Alignment

Our investment philosophy stresses the importance of alignment. Emerging markets present a distinctive context in which to operate a business, with constant evolution – and sometimes revolution – in economic, political, regulatory and financial conditions. Investing alongside managers and owners with good reputations that share our belief in a long-term approach to investment is an important way to align interests.

As a business, we aim to put our investment philosophy into practice. Our remuneration policy is designed to ensure alignment with client outcomes. Partners will co-invest in strategies run by Skerryvore, and the terms of co-investment require holding these investments for a minimum of three years. Consistent with our investment philosophy and process, this underpins an absolute rather than a relative return mind-set that clients can expect from us.

Partnership with BennBridge

BennBridge is a strategic partner, minority owner and the appointed investment manager for Skerryvore Asset Management. It is part of the BFM Group, a privately-owned Australian investment company that partners with boutiques across the globe to deliver actively managed funds. BennBridge is responsible for providing all operational, compliance and regulatory services required by Skerryvore as well as client and distribution support. This provides the operational platform and oversight that allows us to focus on our core strength of investing.



“WE BELIEVE IN MANAGING CLIENTS' MONEY AS WE WOULD OUR OWN”

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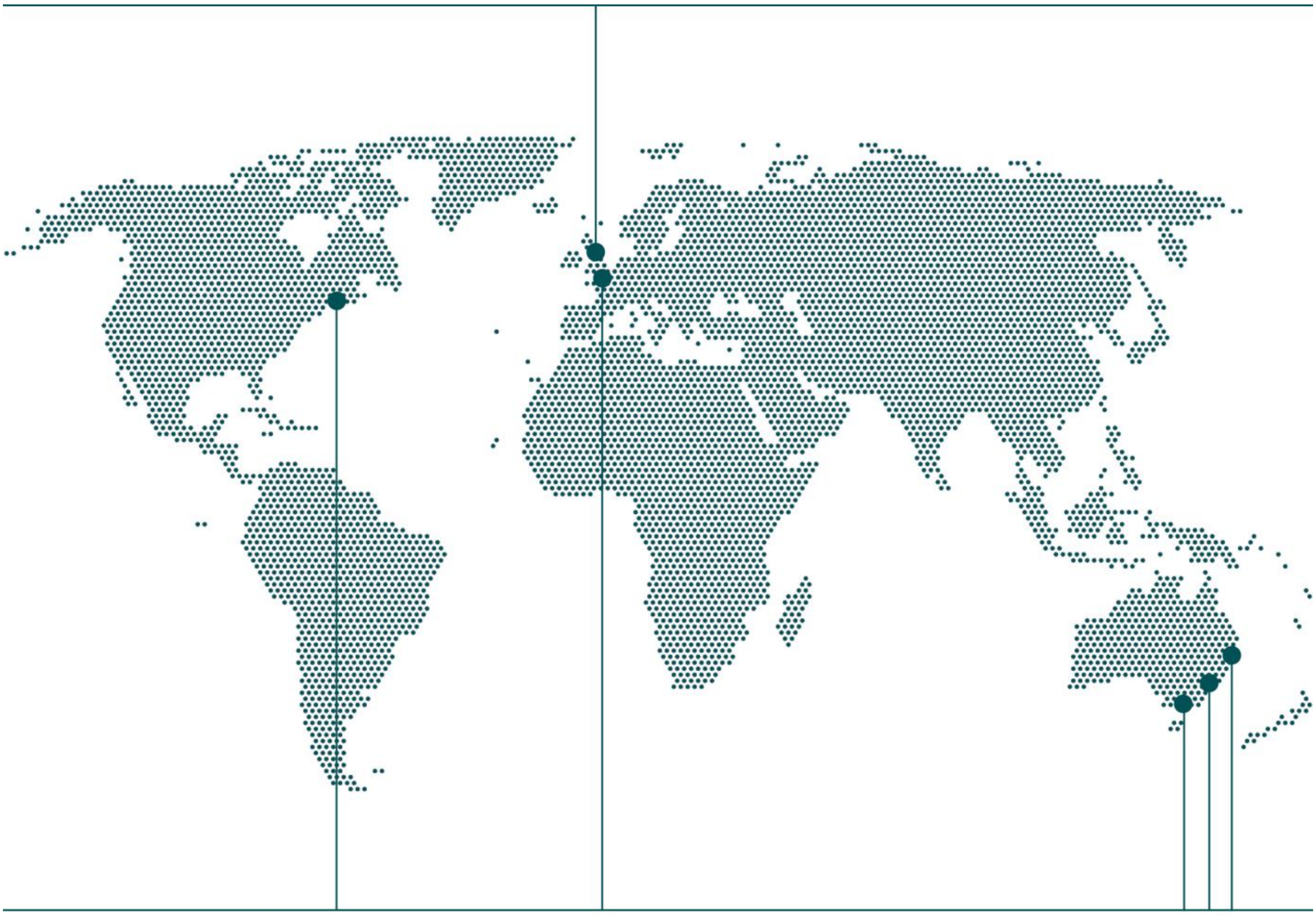

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