

SKERRYVORE GLOBAL EMERGING MARKETS EQUITY STRATEGIES

Research Review

2021



Skerryvore

bennbridge



CUSTOMS
BANGKOK

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Front cover: Pagoda style lighthouse at Ko Sichang, Chonburi province in Thailand

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Stock examples

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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 you 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.

Being open-minded 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?

We start with some thoughts on **adding to our watchlist in China**, with a discussion around our approach to finding opportunities despite the significant challenges of alignment there.

Our search for companies with strong pricing power led us into the innovative pharmaceutical space and we next discuss how we look for **risk-aware ways to gain exposure to rising healthcare expenditure** across emerging markets, followed by a specific look at the **prospects for growth** in the pharmacy sector.

Finally, with all the excitement surrounding the electrification of four-wheeled transport, we discuss our work on the **evolving two-wheeler market**, given its importance in many developing countries. These countries may lack the infrastructure of developed markets but they have the same desire to decarbonise their transportation industries.

We hope you will find this document interesting and useful. Should you have any follow-up questions or thoughts, please do feel free to get in touch.

“ FAR-SIGHTED AND FAIR-MINDED INVESTORS
IN EMERGING MARKETS ”



Tackling the Dragon

The rise of China presents challenges for fundamental, long-term, bottom-up investors who, like us, look to be aligned with those in control of capital allocation at the companies in which they invest.

The high level of state ownership across the Chinese economy creates alignment risks for foreign minority investors. In fact, very few state-controlled businesses anywhere in emerging markets make it onto our watchlist, given our core demands for alignment and sustainability.

China Specific Challenges

The relatively low level of transparency provided by many companies listed on the domestic stock exchange can also make establishing true ownership a challenge. We insist on knowing who we are invested alongside and how they have built their business.

Assessing the risk of modern slavery is essential for all emerging market investments but is especially important in China, given accusations of widespread human rights abuses in Xinjiang province. We are wary of businesses operating in Xinjiang but have also learned from companies operating elsewhere in China that labour agents offer workers from the province nationwide.

Rising geopolitical tensions mean we must also consider sanction risk when looking at Chinese equities. This clearly applies to state-owned and state-affiliated businesses but also increasingly to those perceived to be benefiting from intellectual property (IP) acquired from rival powers.

Growing sanctions lists include everything from state-owned telecom operators to notionally private artificial intelligence and biotechnology companies. Sanctions cut both ways and foreign companies can be barred from China's market and overseas listed Chinese businesses forced to return home.

Risks to Overseas Listed Entities

There are additional specific risks that minority shareholders in overseas listed Chinese entities need to consider. We have avoided investing in Chinese technology and education companies in part due to the lack of protection provided by the variable interest entity (VIE) legal structures they use.

The decision to convert the tutoring industry into not-for-profit, as well as the enormous charitable donations in the name of common prosperity announced by online businesses Alibaba and Tencent, serve as a reminder of the tenuous claim overseas shareholders in VIEs have on underlying profits.

China's real estate industry, which for decades has underpinned its economy, has been destabilised by property developer Evergrande's spiralling debt crisis, which has also exposed the plight of offshore bond investors who, with around \$20 billion in exposure, now look extremely vulnerable.

Despite these challenges, since we established Skerryvore the number of Chinese companies on our investible watchlist has steadily increased.

Many of these are businesses whose shares are listed on local rather than international stock exchanges because this, in our opinion, creates better alignment with domestic investors – partly because the Chinese government has some incentive to avoid disadvantaging them.

There we find founders and managers who have built franchises in parts of the economy that are, in theory, less likely to attract the attention of governments or regulators.

Emerging Chinese Multinationals

Bearing in mind a common criticism of domestic franchises is the lack of tolerated foreign competition, we are actively interested in emerging Chinese multinationals that have turned homegrown competencies into overseas success.

In that light we have investigated businesses such as **Xingyu Automotive Lighting**, a Changzhou-based manufacturer of automotive lighting, and we continue to admire China's leading auto-glass manufacturer **Fuyao Glass**, for its success in the US and European markets.

Reputation as a Competitive Advantage

We are also attracted to areas where reputation is a competitive advantage, such as the testing industry where the entire value of the service relies on the integrity of the certification being provided. Interesting companies identified here include **Centre Testing International**.

Similarly, a strong reputation is crucial to success in the contract research organisation (CRO) space, where a business partner needs to trust that its IP will be respected. Privately rather than government controlled **Hangzhou Tigermed Consulting** has a history of successful collaborations with multinational pharmaceutical companies and, at the right price, we would deem it good enough to own.

We often see the value of applying the lessons learned through our research in one area to another area. This has led to our investigation of the fragmented Chinese pharmacy sector, including **DaShenLin Pharmaceutical** and **Yifeng Pharmacy Chain** where we believe the potential for the successful consolidation we have seen elsewhere is strong.

Rising property prices have been a strong driver of Chinese consumer spending. With prices now under pressure, this powerful tailwind may be coming to an end and, as a result, we have looked for resilient businesses where the downturn may create an opportunity for the long-term investor. These include household appliance makers with strong brands and vendors of luxury vehicles.

Homegrown Consumer Winners

Although we do have exposure to Chinese consumption via multinational businesses operating locally and domestic companies partnered with international brands, we have been searching for homegrown consumer winners, which focus on building Chinese brands, and recently added domestic cosmetics company **Proya Cosmetics** to the watchlist.

Despite a growing watchlist, over the course of 2021 our strategy's exposure to Chinese equities has in fact fallen. These contradictory movements are a function of valuation rather than quality.

We continue to search for companies that pass our quality threshold. Should fears over sanctions, regulation or property market stress bring about a wider de-rating of these good-quality Chinese equities, we are poised to add new names to the portfolio.

Enablers of Innovation

Less than 10% of new drugs that enter clinical trials are ultimately approved. It's a risky business, both for the companies involved and their potential investors. Losses can be significant especially considering the average cost to develop a new medicine is estimated to be in the billions of dollars. However, it is still possible for our strategies to benefit from breakthrough innovations in medical science without risking the permanent loss of capital by betting on the success of individual drugs.

This is because we look for industries and businesses that support these individual risk takers. These are the proverbial suppliers of picks and shovels to the innovative gold miners of our age. It's a formula that we have adopted successfully in other industries experiencing technological transformation.

New drugs can fail for any number of reasons but the most common are poor efficacy or safety issues. Sometimes it is difficult to recruit enough volunteers for trials to reach meaningful conclusions, particularly when looking to treat rare conditions. In other cases, drugs fail at the manufacturing stage if the finished doses cannot be made to a consistent quality.



Backing the Service Providers who the Innovators Depend On

To the select innovators who successfully overcome these hurdles, the reward of patent protection and pricing power awaits, but the difficulty in consistently identifying the future blockbusters among the myriad of failures is clear. For this reason, we tend to avoid investing in early-stage or single-drug companies, preferring to look at pharma companies with established portfolios of products and cash flows.

Contract research organisations (CRO's) have existed for decades but the industry really took off about 10 years ago as large pharma companies, forced to bring down their own costs by a wave of pressure from loss of exclusivity on their patents, accelerated their outsourcing of drug development work.

CROs have benefited from this trend and today their level of penetration is roughly 40% of the global pharmaceutical R&D expenditure. Outsourcing this function is far more cost-efficient because a CRO can conduct multiple development projects simultaneously, allowing it to maximise the use of laboratories and clinical staff, whereas in-house teams at pharma companies would face periods of idle capacity when pipelines dry up or molecules fail to progress.

Furthermore, most biotech companies prefer to concentrate on the IP and have no wish to build out the physical infrastructure or the teams of scientists required to bring a drug right through to commercialisation.

India and China Climb the Value Chain

Emerging markets have long played a role in the global pharma supply chain, with India and China being the primary manufacturing centres for the raw materials that go into the finished doses. However, we are now seeing them progress up the value chain from low-cost generic producers to innovative IP owners.

Indeed, China is now the second-largest pharmaceutical market in the world and in the past decade a well-funded domestic biopharma industry has emerged. This has coincided with supportive government policies to help streamline the drug research timelines and harmonise approval processes with global standards. All this bodes well for long-term structural growth for the Chinese CRO industry as this innovation is brought to fruition.

India lags behind in terms of the development of its own pharma IP, though there are signs of the large pharma players progressing up the complexity curve – **Cipla** continues to impress us with its advances in treating respiratory conditions. Service providers have also evolved here, offering multinationals a cost-effective solution for outsourcing the early stages of drug discovery and development work as well as small-batch manufacturing for the clinical trials process.

Our hope is that these businesses can capture more of the development and commercial-scale manufacturing work through time.

Some of the emerging market listed participants in the CRO industry exude the characteristics we search for in our investments: companies backed by private individuals rather than the state, reputations built over many years via trust-based partnerships and business practices on a par with the best global peers. Valuations remain a little above our estimate of fair value, but **Hangzhou Tigermed Consulting** (China) and **Syngene** (India) are two that remain closely monitored on our watchlist.

“ CHINA IS NOW THE SECOND-LARGEST PHARMACEUTICAL MARKET IN THE WORLD ”



Expanding Markets

Companies that can use an already successful approach to exploit an under-penetrated opportunity within poorly served markets can lead to attractive and sustainable long-term returns for those with the cultural, organisational and technological skills to replicate success.

This is certainly the case in the emerging markets healthcare industry and, we would argue, for pharmacy operators in particular after witnessing the success of certain companies as they have consolidated their market in other, more developed countries.

Healthcare Consolidation and Expansion

The leading South African pharmacy operator **Clicks** is an excellent example of how to leverage a successful expansion template. In the mid-2000s they hired a CEO from the UK's leading pharmacy operator **Boots** to replicate the same model across South Africa, with great and ongoing success.

In Brazil, the leading drugstore operator **Raia Drogasil** has helped to consolidate an extremely fragmented market, and in recent years Mexico's **FEMSA**, better known for its Oxxo convenience store chain, has been steadily building a portfolio of drugstores across Latin America.

Pharmacies in China: An Emerging Consolidation Opportunity

Our research work has highlighted that there may be a comparable opportunity for the drugstore model in China, a similarly immature market where demographics paint a picture of a rapidly aging population demanding progressively more healthcare support. Companies such as **DaShenLin Pharmaceutical**, Guangdong's leading pharmacy operator, and **Yifeng Pharmacy Chain**, another nationwide player, have been providing interesting food for thought.

There are around half a million drugstores in China where, in 2020, the top five players had 15% market share; by contrast, in the US the top three had 85%¹. The opportunity to consolidate the market is significant, but we also need to remember that these are drugstores with 'Chinese characteristics'.

There are several subtle differences between the pharmacy models we are familiar with elsewhere and those in China. For example, the vast majority of prescription drugs in China are collected from a hospital, rather than a retail pharmacy, and sales of front-of-store health and beauty products in these stores are low as a result.

However, owing to corruption within hospitals, healthcare authorities are attempting to force prescriptions out of hospitals and into retail pharmacies. Understanding whether this can be successful and whether drugstores in China can capture additional sales of non-pharmacy products are key points in our investigation.

Pharmacy companies provide investors with access to the trend of rising demand for healthcare in a business format that emulates a number of proven developed world success stories. 'Imitation is the sincerest form of flattery' and it is our aim to shine a light on those companies that can replicate this success in the emerging world.

¹ Jefferies Research

Thinking about Cycles

If you own a bicycle, there's a very good chance it was made, or assembled, in Taiwan. There's a common misperception that emerging markets are about compromise in terms of franchise, alignment or even ways of doing business but this is increasingly inaccurate.

We have a firm belief that the best companies in emerging markets are among the best companies anywhere in the world and this has certainly been true in our experience with two-wheeled transport.

Take for example **Giant** and **Merida**, two of Taiwan's largest bike companies based in Taichung, about a two-hour train ride from Taipei. Both companies were founded in the 1970s and have withstood tremendous competitive pressure from China's low-cost labour model to become integral to cycling everywhere in the world. They show a path of progression from low-cost labour, to manufacturing and supply chain excellence to brand and IP building in two slightly different ways.

Moving from Low Value-Added to Global Champion

Giant is now known as a brand around the world and behind the scenes helps many other companies with design and manufacturing. With the move to e-bikes, the company has started to develop its own technology to complement a growing line of high-margin accessories, which is growing its intangible value.

Merida, on the other hand, made a different strategic choice to buy a 35% stake in Specialized, a leading-edge, US-based bike brand, when they were under stress, allowing Merida to stay more focused on manufacturing but giving them access to cutting-edge design and a global brand².

The supply chain that exists around these companies is hard to replicate and difficult for new brands to compete with, making these two businesses globally competitive.

The theme of moving from low value-added to global champion, capable of competing with players from anywhere in the world, is also reflected in our decision to invest in **Bajaj Auto**. From more humble beginnings importing scooters into India, Bajaj has risen to become one of the largest motorcycle manufacturers in the world.

With a home market of over 1 billion people, most Indian companies have their hands full domestically but Bajaj has become a truly global company selling motorcycles everywhere from Argentina to Austria.

The CEO, Rajiv Bajaj, overcame the challenge of a big shift in the market from scooters to motorbikes in the 1990s by focusing on brand building and strategic marketing.

The Bajaj family has also invested cleverly to gain access to technology and higher-end brands alongside Stefan Pierer, the owner of the eponymously named Pierer Mobility that owns the KTM brand, combining a little of what both Giant and Merida have done so effectively.

² Bloomberg data



Over the past decade the popularity of scooters has been revived, if not yet quite come full circle, with demand increasingly driven by tougher emissions and safety regulations as well as rising insurance premiums for alternatives.

The environmental footprint of a bike or scooter is much lower than that of a car and the advent of electric powered bicycles and scooters could well mean a future with more of these vehicles replacing cars in cities. India for example has 14 out of the 20 most polluted cities in the world and this is leading to a strong appetite from governments and urban planners to electrify and decarbonise the transport industry³. As in some other emerging markets, it is evolving quite differently from the electric car led solution favoured in developed economies, given the lack of sophisticated infrastructure.

³ www.who.int/data/gho/data/themes/topics/topic-details/GHO/ambient-air-pollution

Going Electric

Bajaj Auto introduced its first e-scooter, the Chetak in 2019 and is fully expected to be part of the solution as the maker of electric vehicles and the service network required.

It should also be said that, just as the move from pedal bikes to battery assistance is opening cycling and scooting up to a larger market, motorcycles too are undergoing a transformation away from the internal combustion engine.

We believe a combination of long-term investing either internally or alongside good partners makes companies exposed to this trend, including those mentioned above, likely to succeed in an increasingly electric-powered world of transport.



About us

Introduction

The Skerryvore lighthouse marks a treacherous reef of rocks that lies off of 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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